Resnik v. Commissioner, 66 T. C. 74 (1976)

The Commissioner may disallow a partnership's deduction for prepaid interest if it materially distorts the partnership's income.

Summary

In Resnik v. Commissioner, the U. S. Tax Court upheld the Commissioner's disallowance of a partnership's prepaid interest deduction, which was claimed by Bernard Resnik, a limited partner, on his 1969 tax return. The partnership, San Jose Co. , prepaid interest for over four years on its one-day taxable year, December 31, 1969, resulting in a significant loss for the partners without any corresponding income. The court ruled that this practice materially distorted the partnership's income, justifying the Commissioner's use of discretion under IRC section 446(b) to disallow the deduction. This case underscores the importance of the partnership level in determining income distortion and reinforces the broad discretion granted to the Commissioner in ensuring clear reflection of income.

Facts

Bernard Resnik was a limited partner in San Jose Co. , an Illinois limited partnership formed on December 31, 1969. On the same day, the partnership purchased an undivided interest in Texas real estate from Capital Concepts Corp. and prepaid $115,000 in interest for approximately 4 years and 3 months. This was the partnership's only transaction during its one-day taxable year. The partnership reported no income and claimed a $115,000 deduction for the prepaid interest, resulting in a $115,000 loss. Resnik claimed his distributive share of this loss, $36,800, on his joint 1969 tax return.

Procedural History

The Commissioner disallowed the prepaid interest deduction, asserting that it materially distorted the partnership's income. Resnik and his wife filed a petition with the U. S. Tax Court, challenging the Commissioner's determination. The Tax Court upheld the Commissioner's disallowance of the deduction and ruled in favor of the Commissioner.

Issue(s)

1. Whether the Commissioner abused his discretion under IRC section 446(b) by disallowing the partnership's deduction for prepaid interest on the grounds that it materially distorted the partnership's income?

Holding

1. No, because the prepaid interest deduction for a period extending over four years on the partnership's one-day taxable year resulted in a material distortion of the

partnership's income, and the Commissioner did not abuse his discretion in disallowing the deduction to more clearly reflect the partnership's income.

Court's Reasoning

The court's decision was grounded in the broad discretion granted to the Commissioner under IRC section 446(b) to ensure that taxable income is clearly reflected. The court emphasized that the distortion of income must be examined at the partnership level first, as the partnership controls the timing of its transactions, including the prepayment of interest. The court found that the prepayment of interest for over four years on a one-day taxable year, resulting in a significant loss without any corresponding income, was a clear distortion of the partnership's income. The court cited Andrew A. Sandor (62 T. C. 469 (1974)) and other cases to support its decision, rejecting arguments that the distortion should be examined at the partner level. The court concluded that the Commissioner did not abuse his discretion in disallowing the deduction to prevent the distortion of income.

Practical Implications

This case has significant implications for tax planning involving partnerships, particularly in the context of prepaid interest deductions. It underscores the importance of examining income distortion at the partnership level and reinforces the broad discretion granted to the Commissioner under IRC section 446(b). Practitioners should be cautious when structuring transactions that involve prepaid interest, especially in short taxable years, as such deductions may be disallowed if they result in a material distortion of the partnership's income. This case also serves as a reminder that the partnership's method of accounting and the timing of its transactions can have a significant impact on the tax treatment of its partners. Subsequent cases have consistently followed the reasoning in Resnik, further solidifying the principle that the Commissioner's discretion under section 446(b) is to be given deference in cases involving potential income distortion.

