Harry L. Marriott and Patricia Marriott, and Lester Earl Sutton and Marjory R. Sutton, Petitioners v. Commissioner of Internal Revenue, Respondent, 73 T. C. 1129; 1980 U. S. Tax Ct. LEXIS 165 (1980)

Partnership losses cannot be retroactively allocated to new partners who did not own the interest during the period the losses were incurred.

Summary

In Marriott v. Commissioner, the U. S. Tax Court ruled that new partners in a limited partnership could only deduct losses allocable to the period after they acquired their partnership interests. The Marriotts and Suttons purchased units in Metro Office Parks Co. late in the tax years 1972 and 1973, respectively. Despite the partnership agreement's provision to allocate losses based on year-end ownership, the court held that under Section 706(c)(2)(B) of the Internal Revenue Code, losses must be prorated between the transferor and transferee based on their respective periods of ownership. This decision reaffirmed the principle from Moore v. Commissioner that partnership losses must be allocated according to the partners' economic interest during the taxable year, preventing the retroactive shifting of tax benefits.

Facts

Harry L. Marriott acquired five limited partnership units in Metro Office Parks Co. in December 1972, while Lester Earl Sutton acquired one unit in April 1973. Metro's partnership agreement, amended on December 30, 1971, allocated net income and losses based on the proportion of units owned by each limited partner at the end of the fiscal year. The IRS challenged the deduction of losses by Marriott and Sutton, arguing that they should only be allowed to deduct losses allocable to the period after acquiring their units.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the taxpayers' income taxes for the years 1972 and 1973, disallowing deductions for partnership losses allocable to periods before the taxpayers acquired their units. The taxpayers petitioned the U. S. Tax Court, which upheld the Commissioner's determination, following its prior ruling in Moore v. Commissioner.

Issue(s)

1. Whether petitioners may deduct partnership losses allocable to the periods during the taxable years prior to the time they acquired the partnership interests.

Holding

1. No, because under Section 706(c)(2)(B) of the Internal Revenue Code, partnership

losses must be prorated between the transferor and transferee based on their respective periods of ownership during the taxable year.

Court's Reasoning

The court reasoned that Section 706(c)(2)(B) supersedes Section 704(a) when there is a transfer of partnership interests during the taxable year. It emphasized that the partnership agreement's provision for allocating losses based on year-end ownership was overridden by the statutory requirement to allocate losses according to the partners' economic interest during the year. The court cited Moore v. Commissioner, where it was established that retroactive allocation of losses to new partners violates the assignment-of-income doctrine. The court also noted that the partnership's method of allocating losses did not reflect the economic reality of the partners' interests during the year, as it allocated losses to Marriott and Sutton that accrued before they were partners. The concurring opinion by Judge Nims reinforced the majority's view, highlighting that the retroactive allocation of losses was contrary to the principle that the taxpayer who sustained the loss should be the one to claim the deduction.

Practical Implications

This decision has significant implications for the structuring of partnership agreements and the timing of partnership interest acquisitions. It clarifies that partnership losses cannot be retroactively shifted to new partners, which affects tax planning strategies involving the timing of entry into partnerships. Practitioners must ensure that partnership agreements comply with Section 706(c)(2)(B) by prorating losses according to the partners' actual periods of ownership. This ruling also underscores the importance of aligning tax allocations with the economic reality of the partners' interests to avoid disallowance of deductions. Subsequent cases have followed this principle, reinforcing the need for careful consideration of the tax consequences of partnership interest transfers.