Estate of Hesse v. Commissioner, 74 T. C. 1307 (1980)

A decedent's distributive share of partnership losses for the year of death must be reported on the estate's fiduciary income tax return, not on the decedent's final joint return.

Summary

In Estate of Hesse v. Commissioner, the Tax Court ruled that partnership losses incurred in the year of a partner's death must be reported on the estate's tax return rather than on the decedent's final joint return. Stanley Hesse, a general partner, died mid-year, and his widow attempted to claim his share of the partnership's substantial losses on their joint return to utilize a net operating loss carryback. The court held that under Section 706(c)(2)(ii) of the Internal Revenue Code, these losses must be reported by the estate, thus preventing the widow from obtaining significant tax refunds. This decision underscores the application of statutory rules over potential tax advantages for survivors and highlights the need for legislative reform in this area.

Facts

Stanley Hesse was a general partner in H. Hentz & Co. , a limited partnership, when he died on July 16, 1970. The partnership sustained substantial losses in 1970, including losses from operations and errors in securities transactions known as "cage errors. " Hesse's share of these losses was $391,587. 18. His widow, Elizabeth Hesse, filed a joint return for 1970 claiming these losses, seeking to carry them back to 1967 and 1968 for tax refunds. The Commissioner disallowed this, asserting that the losses should be reported on the estate's return for the fiscal year ending June 30, 1971.

Procedural History

The Commissioner determined deficiencies in the Hesses' income taxes for 1967 and 1968, disallowing the partnership loss deductions on their 1970 joint return. The Hesses petitioned the Tax Court, contesting where the partnership losses should be reported. The Tax Court ruled in favor of the Commissioner, affirming that the losses must be reported by the estate.

Issue(s)

1. Whether the decedent's distributive share of partnership losses for the year of death can be reported on the final joint return filed by the decedent's surviving spouse, allowing for a net operating loss carryback.

Holding

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

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year of a partnership does not close upon a partner's death, and the decedent's distributive share of partnership losses must be reported on the estate's fiduciary income tax return.

Court's Reasoning

The court's decision was based on the clear statutory language of Section 706(c)(2)(ii), which states that the taxable year of a partnership does not close with respect to a partner who dies during the year. The court emphasized that this provision, enacted to prevent "bunching of income," now operates to the detriment of successors in interest like Elizabeth Hesse. The court rejected the argument that Hesse's partnership interest was liquidated at his death, noting that the final accounting with the partnership occurred years later. Additionally, the court found no basis for a deductible loss under Section 165(a) at the time of Hesse's death due to the lack of a closed transaction. The court acknowledged the inequities of the current law but felt bound by the statute, suggesting that Congress should address these issues.

Practical Implications

This ruling impacts how estates and surviving spouses handle partnership losses upon a partner's death. It reinforces that such losses must be reported on the estate's return, potentially limiting the use of net operating loss carrybacks. Practitioners should advise clients on the importance of estate planning that accounts for potential partnership losses and the limitations on carrybacks. This case may spur calls for legislative reform to address the perceived unfairness, especially in cases where the tax burden significantly affects the surviving spouse. Subsequent cases have continued to apply this rule, though some have noted its harsh effects, suggesting possible future changes in law or policy.

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