Sennett v. Commissioner, 69 T. C. 694 (1978)

A former partner cannot deduct partnership losses in a year after selling his partnership interest, even if he repays his share of those losses to the partnership.

Summary

In Sennett v. Commissioner, the Tax Court ruled that William Sennett could not deduct his share of partnership losses in 1969, the year after he sold his interest in the Professional Properties Partnership (PPP). Sennett had paid PPP $109,061 in 1969, representing his share of losses from 1967 and 1968. The court held that under section 704(d) of the Internal Revenue Code, such a deduction was not allowable because Sennett was no longer a partner when he made the payment. The decision emphasizes that partnership losses can only be deducted at the end of the partnership year in which they are repaid, and this does not apply to former partners who have sold their interest.

Facts

William Sennett became a partner in Professional Properties Partnership (PPP) in December 1967, contributing $135,000 for a 33. 50% interest. In 1967, PPP reported an ordinary loss of $405,329, with Sennett's share being $135,785. By the beginning of 1968, Sennett's capital account had a negative balance of $785. On November 26, 1968, Sennett sold his interest in PPP back to the partnership for $250,000, payable over time. The agreement also required Sennett to pay PPP his share of the partnership's accumulated losses. In May 1969, the sale agreement was amended, reducing the purchase price to $240,000. In 1969, Sennett paid PPP $109,061, representing 80% of his share of the 1967 and 1968 losses. Sennett attempted to deduct this amount on his 1969 tax return.

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency to Sennett for the 1969 tax year, disallowing the claimed deduction of $109,061. Sennett petitioned the Tax Court for a redetermination of the deficiency. The case was fully stipulated, and the Tax Court issued its opinion in 1978.

Issue(s)

1. Whether section 704(d) allows a former partner to deduct, in 1969, his payment to the partnership of a portion of his distributive share of partnership losses which was not previously deductible while he was a partner because the basis of his partnership interest was zero.

Holding

1. No, because section 704(d) only allows a partner to deduct losses at the end of

the partnership year in which the loss is repaid to the partnership, and Sennett was no longer a partner in 1969 when he made the payment.

Court's Reasoning

The court's decision hinged on the interpretation of section 704(d), which limits the deductibility of partnership losses to the adjusted basis of the partner's interest at the end of the partnership year in which the loss occurred. The court emphasized that any excess loss over the basis can only be deducted at the end of the partnership year in which it is repaid to the partnership. Since Sennett sold his entire interest in December 1968, his taxable year with respect to PPP closed under section 706(c)(2)(A)(i), and he was not a partner in 1969 when he repaid the losses. The court also noted that the Senate Finance Committee's report supported this interpretation, stating that the loss is deductible only at the end of the partnership year in which it is repaid, either directly or out of future profits. The court rejected Sennett's argument that he had a continuing obligation to pay for the losses, finding no clear evidence of such liability outside the sale agreement. The court also distinguished the House version of section 704(d), which focused on the partner's obligation to repay losses, from the enacted version, which ties deductions to the partner's adjusted basis.

Practical Implications

This decision clarifies that former partners cannot deduct partnership losses in a year after they have sold their partnership interest, even if they repay their share of those losses to the partnership. This ruling impacts how attorneys should advise clients on the tax consequences of selling a partnership interest, particularly in situations where the partnership has accumulated losses. Practitioners should ensure that clients understand that any obligation to repay partnership losses after selling an interest does not allow for a deduction of those losses in subsequent years. This case also underscores the importance of considering the timing of loss repayments in relation to partnership years and the partner's adjusted basis. Subsequent cases, such as Meinerz v. Commissioner, have followed this precedent, reinforcing that losses cannot be allocated to partners who entered the partnership after the losses were sustained.