

## ***Johnsen v. Commissioner, 83 T. C. 103 (1984)***

Partners can deduct certain pre-operational expenses under IRC Section 212, but not under Section 162 until the partnership is actively operating.

### **Summary**

In *Johnsen v. Commissioner*, the U. S. Tax Court addressed the deductibility of expenses incurred by a limited partnership before it began operating its apartment project. The partnership, formed in 1976, incurred costs related to loan commitments, management, and legal and consulting fees but had not yet started its rental business by year-end. The court held that these pre-operational expenses were not deductible under Section 162 as the partnership was not yet carrying on a trade or business. However, the court allowed deductions for some expenses under Section 212, which permits deductions for expenses incurred to produce income or manage income-producing property. The decision highlighted the distinction between Sections 162 and 212 and clarified the tax treatment of pre-operational costs, impacting how similar cases are analyzed and emphasizing the importance of the partnership's operational status in determining expense deductibility.

### **Facts**

In April 1976, a limited partnership was formed to develop an apartment project known as Centre Square III. The partnership secured financing and executed a management agreement with a general partnership. Construction began in September 1976, but no tenants occupied the apartments until June 1977. During 1976, the partnership incurred expenses for loan commitment fees, management fees, legal fees, and consulting fees. The partnership did not generate any rental income in 1976 and was not fully operational by the end of the year.

### **Procedural History**

The Commissioner of Internal Revenue disallowed the partnership's deductions for the 1976 expenses, leading *Johnsen*, a limited partner, to petition the U. S. Tax Court. The Tax Court heard the case and issued its opinion in 1984, addressing the deductibility of the expenses under Sections 162 and 212 of the Internal Revenue Code.

### **Issue(s)**

1. Whether the limited partnership was carrying on a trade or business as of December 31, 1976, allowing deductions under Section 162?
2. If not, whether the partnership's expenses for loan commitment fees and management fees were deductible under Section 212(1) or (2)?
3. Whether the partnership's legal fees and consulting fees were deductible under Section 212(3)?
4. Whether the petitioner's distributive share of partnership items should be

adjusted to reflect his varying interest during the partnership's 1976 taxable year?

## **Holding**

1. No, because the partnership was not actively operating its rental business by the end of 1976, and thus could not deduct expenses under Section 162.
2. Yes, because the loan commitment fees and management fees were incurred to produce income or manage income-producing property, allowing deductions under Section 212(1) or (2), except for a portion of the permanent loan commitment fee deemed excessive.
3. No, because the petitioner failed to prove that any portion of the legal fees and consulting fees were deductible under Section 212(3) or not organizational/syndication expenses under Section 709.
4. Yes, because the petitioner's distributive share must be adjusted to account for his varying interest in the partnership during 1976.

## **Court's Reasoning**

The court reasoned that under Section 162, deductions are only allowed for expenses incurred while carrying on a trade or business. Since the partnership had not yet commenced its rental operations by the end of 1976, it could not deduct expenses under this section. However, the court allowed deductions under Section 212, which does not require an active trade or business, for expenses related to producing income or managing income-producing property. The court found that loan commitment fees and management fees met these criteria but disallowed a portion of the permanent loan commitment fee as excessive. Legal and consulting fees were not deductible under Section 212(3) because the petitioner could not prove their deductibility or that they were not organizational/syndication expenses under Section 709. The court also applied Section 706(c)(2)(B), requiring the petitioner's distributive share to be adjusted due to his varying interest during the partnership's taxable year.

## **Practical Implications**

This decision clarifies that pre-operational expenses of a partnership can be deductible under Section 212 but not under Section 162 until the partnership is actively operating. Tax practitioners must carefully analyze the nature of expenses and the partnership's operational status when advising clients on deductions. The ruling also underscores the need to substantiate the deductibility of legal and consulting fees, as they may be considered non-deductible organizational or syndication expenses. Additionally, the case emphasizes the importance of accounting for a partner's varying interest in the partnership when calculating their distributive share of income and losses. Subsequent cases, such as *Hoopengarner v. Commissioner*, have applied and distinguished this ruling, further shaping the tax treatment of pre-operational partnership expenses.