John K. Johnsen and Frances Johnsen v. Commissioner of Internal Revenue, 84 T. C. 344 (1985)

The Commissioner has the burden of proving the applicability of Section 706(c)(2)(B) for varying partnership interests, but need only apply a reasonable method of allocation, not the most favorable to the taxpayer.

Summary

In Johnsen v. Commissioner, the U. S. Tax Court addressed how to allocate partnership deductions under Section 706(c)(2)(B) when a partner joins mid-year. Johnsen joined a limited partnership after its formation and sought to deduct his share of partnership losses without adjustment. The Commissioner argued that Johnsen's share should be prorated based on the time he was a partner. The court held that the Commissioner met his burden by applying the proration method, a reasonable allocation method, and that Johnsen failed to prove facts necessary for using the more favorable interim closing of the books method. This ruling clarifies the Commissioner's burden and the flexibility in choosing allocation methods for varying partnership interests.

Facts

John K. Johnsen became a limited partner in Centre Square III, Ltd. on July 19, 1976, after its formation on April 11, 1976. The partnership incurred various expenses in 1976, including construction and permanent loan commitment fees and a management and guarantee fee. Johnsen claimed deductions for his share of these expenses on his 1976 tax return. The Commissioner argued that under Section 706(c)(2)(B), Johnsen's share should be reduced to reflect his partial-year membership, using the proration method. Johnsen contended that all expenses accrued after his entry and sought to use the interim closing of the books method, which would result in no reduction of his share.

Procedural History

The U. S. Tax Court initially held in 83 T. C. 103 (1984) that Johnsen was entitled to deduct his distributive share of certain partnership expenses, but did not decide the allocation method for his varying interest. Following this, the Commissioner applied the proration method in his Rule 155 computation, leading to a decision of a $2,698 deficiency for Johnsen. Johnsen moved to vacate this decision, arguing for the interim closing method. The court heard arguments on this motion and issued the supplemental opinion in 84 T. C. 344 (1985), denying Johnsen's motion to vacate.

Issue(s)

1. Whether the Commissioner's burden of proof under Section 706(c)(2)(B) extends to applying the allocation method most favorable to the taxpayer?
2. Whether the proration method used by the Commissioner is a reasonable method

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of allocation under Section 706(c)(2)(B)?
3. Whether Johnsen can use the interim closing of the books method to allocate partnership deductions?

Holding

1. No, because the Commissioner's burden is satisfied by proving the applicability of Section 706(c)(2)(B) and applying a reasonable allocation method, not necessarily the most favorable to the taxpayer.
2. Yes, because the proration method, which allocates partnership items ratably over the partnership year, is a reasonable method of allocation under Section 706(c)(2)(B).
3. No, because Johnsen failed to prove that the partnership's expenses accrued after his entry, which is necessary for applying the interim closing of the books method.

Court's Reasoning

The court reasoned that the Commissioner's burden of proof under Section 706(c)(2)(B) is to show the applicability of the section and apply a reasonable allocation method, not necessarily the method most favorable to the taxpayer. The proration method was deemed reasonable because it is straightforward and commonly used. Johnsen's argument for the interim closing method required proof that the expenses accrued after his entry into the partnership. The court found that Johnsen failed to prove this, as the bulk of the expenses were treated as incurred before his entry. The court also noted that subsequent amendments to Section 706(c)(2)(B) reinforced its decision against retroactive allocation of losses. The court quoted from its opinion that "the proration method selected by the Commissioner is reasonable" and cited legislative history indicating flexibility in choosing allocation methods.

Practical Implications

This decision provides clarity on the Commissioner's burden of proof and the flexibility in choosing allocation methods under Section 706(c)(2)(B). Practitioners should note that while the Commissioner must prove the applicability of the section, they need only apply a reasonable method of allocation, not the most favorable to the taxpayer. This ruling may encourage taxpayers to carefully document when partnership expenses are incurred to support the use of the interim closing method. The decision also underscores the importance of understanding the partnership's accounting method, as the accrual method used in this case affected the outcome. Later cases, such as Richardson v. Commissioner, have continued to apply these principles, though with subsequent statutory changes affecting the treatment of certain expenses.

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