Ness v. Commissioner, 94 T. C. 784, 1990 U. S. Tax Ct. LEXIS 51, 94 T. C. No. 47 (T. C. 1990)

A disallowed portion of a deduction does not automatically constitute a 'grossly erroneous item' for innocent spouse relief under section 6013(e)(2) if another portion of the same deduction was allowed.

Summary

In Ness v. Commissioner, the Tax Court addressed whether a disallowed portion of a partnership loss deduction on a joint tax return constituted a 'grossly erroneous item' under section 6013(e)(2)(B) for innocent spouse relief. The Nesses claimed a deduction for their share of losses from a limited partnership, but the IRS disallowed part of it due to lack of at-risk basis. The court held that the disallowed portion did not automatically make the entire deduction 'grossly erroneous,' as the allowed portion had a valid basis in law and fact. This ruling impacts how deductions are analyzed for innocent spouse relief, emphasizing that a partial disallowance does not necessarily preclude relief.

Facts

Gordon and Yvonne Ness filed a joint federal income tax return for 1981, claiming a $103,331 deduction for their distributive share of losses from Research Investors Group (RIG), a California limited partnership. The IRS disallowed $80,289 of the deduction, allowing only $23,042, which was later adjusted to $35,525 representing their cash investment. The disallowed portion related to $71,016 in promissory notes to Menlo Research Corp. , for which the Nesses were not at risk. Yvonne Ness sought innocent spouse relief under section 6013(e), claiming the disallowed deduction was a 'grossly erroneous item. '

Procedural History

The IRS issued a notice of deficiency to the Nesses for $31,153. 93 for the 1981 tax year. The Nesses petitioned the U. S. Tax Court, which fully stipulated the facts under Rule 122. The court's decision focused solely on whether the disallowed deduction constituted a 'grossly erroneous item' under section 6013(e)(2)(B).

Issue(s)

1. Whether the disallowed portion of the partnership loss deduction on the Nesses' 1981 tax return constitutes a 'grossly erroneous item' under section 6013(e)(2)(B).

Holding

1. No, because the mere fact that a portion of the deduction was disallowed does not automatically make it a 'grossly erroneous item' when another portion of the same deduction was allowed.

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Court’s Reasoning

The court analyzed the definition of ‘grossly erroneous item’ under section 6013(e)(2)(B), which requires a deduction to have ‘no basis in fact or law. ‘ The court referenced Douglas v. Commissioner, stating that a deduction has no basis in fact if the expense was never made, and no basis in law if the expense does not qualify as deductible under well-settled legal principles. The Nesses argued that the disallowed portion of their deduction had no basis in law. However, the court rejected this argument, holding that a deduction having some basis in law is not undermined by the disallowance of a portion of it. The court emphasized that ‘disallowance’ does not equate to ‘grossly erroneous item,’ and thus, the partnership deduction had a sufficient basis in law despite the partial disallowance.

Practical Implications

This decision clarifies that for innocent spouse relief under section 6013(e)(2), a partially disallowed deduction does not automatically qualify as a ‘grossly erroneous item. ‘ Legal practitioners must analyze the basis in law and fact for the entire deduction, not just the disallowed portion. This ruling may affect how taxpayers approach innocent spouse relief claims, requiring them to demonstrate that the entire deduction lacks any basis in law or fact. Businesses and tax advisors should consider this when structuring investments and advising on tax positions, as it impacts the potential for innocent spouse relief in cases of joint tax filings. Subsequent cases like Hayman v. Commissioner have further applied this principle, reinforcing the distinction between disallowance and gross error.

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