McKnight v. Commissioner, 99 T. C. 180 (1992)

The court upheld the validity of a Treasury regulation defining partnership items for the same-share rule under the small partnership exception of TEFRA.

Summary

In McKnight v. Commissioner, the Tax Court addressed the validity of a temporary Treasury regulation used to determine whether a partnership qualified for the small partnership exception under TEFRA. The petitioners challenged the regulation, arguing it conflicted with congressional intent. The court found the regulation valid, reasoning that it reasonably implemented the congressional mandate, was issued contemporaneously with the statute, and aligned with the statute's language and purpose. This ruling clarified that only certain partnership items directly affecting tax liability are relevant for determining the same-share rule, impacting how small partnerships are treated under TEFRA.

Facts

Sam and Ann McKnight, partners in the MLSL Partnership, filed a motion to dismiss for lack of jurisdiction, arguing that the partnership should be exempt from TEFRA's unified audit and litigation procedures under the small partnership exception. The partnership reported ordinary and self-employment losses, distributed according to a fixed percentage among partners. The petitioners challenged the validity of the regulation defining partnership items for the same-share rule, asserting it conflicted with the statute's intent.

Procedural History

The McKnights initially filed a motion to dismiss for lack of jurisdiction, which was denied. They then filed motions for reconsideration and to vacate the court's order. The Tax Court, in a previous decision (McKnight I), determined that MLSL was a small partnership based on the same-share rule. The current case focused on the validity of the regulation used to apply this rule.

Issue(s)

1. Whether section 301. 6231(a)(1)-1T(a)(3) of the Temporary Procedural and Administrative Regulations is valid in defining which partnership items are considered for the same-share rule under section 6231(a)(1)(B)(i)(II).

Holding

1. Yes, because the regulation reasonably implements the congressional mandate, was a substantially contemporaneous construction of the statute, and comports with the statute's plain language, origin, and purpose.

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Court’s Reasoning

The court applied a deferential standard to review the regulation, noting that interpretative regulations can be set aside only if they are unreasonable. The court assessed the regulation’s validity by examining its alignment with the statute’s text, purpose, and legislative history. The court found that the regulation reasonably limited the partnership items to those directly affecting partners’ taxable income, such as income, gains, losses, deductions, credits, and certain expenditures. This limitation ensured that only simple partnerships were exempted from TEFRA, aligning with Congress’s intent to treat such partnerships as co-ownerships rather than partnerships. The court cited National Muffler Dealers Association, Inc. v. United States and United States v. Correll to support its approach to regulation review. The court also noted that the regulation was issued soon after the statute’s enactment, adding to its validity.

Practical Implications

This decision clarifies that only partnership items directly impacting tax liability are relevant for the same-share rule, affecting how partnerships qualify for the small partnership exception under TEFRA. Practitioners should focus on these specific items when advising clients on partnership structuring and tax planning. The ruling may influence future regulations and interpretations related to partnership items. Businesses should consider the implications of guaranteed payments and other items excluded from the same-share rule when forming or operating partnerships. Subsequent cases, such as Harrell v. Commissioner, have applied this ruling to similar situations, reinforcing its importance in partnership tax law.

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