Katz v. Commissioner, 116 T. C. 5 (2001)

A partner's entire distributive share of partnership losses for a taxable year must be reported by the partner's bankruptcy estate if the estate holds the partnership interest at the end of the partnership's taxable year.

Summary

Aron B. Katz filed for bankruptcy on July 5, 1990, and claimed partnership losses from the pre-bankruptcy period on his individual tax return. The IRS argued that these losses should be reported by Katz's bankruptcy estate. The Tax Court held that since Katz's bankruptcy estate held the partnership interests at the end of the 1990 taxable year, the entire distributive share, including pre-bankruptcy losses, must be reported by the estate. This decision was based on the interpretation of Sections 706(a) and 1398(e) of the Internal Revenue Code, which govern the timing and allocation of partnership items to a bankruptcy estate.

Facts

Aron B. Katz owned limited partnership interests in several calendar year partnerships. On July 5, 1990, he filed for bankruptcy under Chapter 7. The partnerships allocated his distributive share of income and losses for 1990, with some partnerships subdividing these items into pre-petition and post-petition periods. Katz reported the pre-petition losses on his individual 1990 tax return, totaling $19,122,838, which contributed to a net operating loss (NOL) of $19,262,795. The IRS disallowed NOL carryovers claimed by Katz and his wife for tax years 1991-1994, asserting that these losses belonged to Katz's bankruptcy estate.

Procedural History

Katz and his wife petitioned the Tax Court for a redetermination of the deficiencies. They moved to dismiss the case for lack of jurisdiction, arguing that the IRS should have first adjusted partnership items through a partnership-level proceeding. The Tax Court denied the motion to dismiss, finding that the allocation issue between Katz and his bankruptcy estate was not a partnership item. The court then granted summary judgment to the IRS, ruling that the entire 1990 distributive share should be reported by Katz's bankruptcy estate.

Issue(s)

1. Whether the Tax Court has jurisdiction to determine the allocation of partnership losses between a partner and the partner's bankruptcy estate without a partnership-level proceeding.
2. Whether the pre-petition partnership losses should be reported by Katz in his individual capacity or by his bankruptcy estate.

Holding

1. No, because the allocation of partnership losses between Katz and his bankruptcy estate is not a partnership item under the TEFRA procedures, and thus, does not require a partnership-level proceeding.
2. No, because under Sections 706(a) and 1398(e), the entire distributive share of partnership losses for the year must be reported by the bankruptcy estate since it held the partnership interests at the end of the partnership's taxable year.

Court's Reasoning

The court reasoned that the allocation of partnership items between a partner and the partner's bankruptcy estate is not a partnership item under the TEFRA procedures, as it does not affect other partners and is not determined at the partnership level. The court applied Section 706(a), which deems a partner's distributive share to be received on the last day of the partnership's taxable year, and Section 1398(e), which assigns income from property of the estate to the estate itself. Since Katz's bankruptcy estate held the partnership interests on December 31, 1990, it was entitled to report the entire distributive share, including the pre-petition losses. The court rejected Katz's arguments that the varying interests rule under Section 706(d)(1) or the short taxable year election under Section 1398(d)(2) required a different allocation. The court emphasized that a partner in bankruptcy and the bankruptcy estate are treated as a single partner for TEFRA purposes.

Practical Implications

This decision clarifies that a partner's entire distributive share of partnership losses for a taxable year must be reported by the bankruptcy estate if it holds the partnership interest at the end of the year. Practitioners should advise clients in bankruptcy to report all partnership items for the year to the estate, regardless of when the bankruptcy was filed. This ruling may impact the tax planning strategies of individuals considering bankruptcy, as it affects the allocation of tax benefits between the debtor and the estate. Subsequent cases, such as *Gulley v. Commissioner*, have followed this precedent, reinforcing the principle that the bankruptcy estate is treated as the partner for tax purposes at the end of the partnership's taxable year.