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U.S. Tax Court: Basis in partnership interest must be decreased by losses deducted in prior closed tax years

The U.S. Tax Court yesterday held that the taxpayer, a TEFRA partnership, was required to decrease its basis in its interest in a lower-tier partnership (LTP) under section 705(a) for passthrough losses from the LTP that the taxpayer had deducted in prior closed tax years, even though such losses were in excess of the taxpayer's basis in its LTP interest in those years and thus would have been disallowed under section 704(d).

The case is: *Surk, LLC v. Commissioner*, T.C. Memo 2024-99 (October 29, 2024). Read the Tax Court's opinion

Summary

In 2014 and 2015, the taxpayer deducted passthrough losses from LTP of $1,123,680 and $2,729,129, respectively, even though its basis in its LTP interest in 2014 prior to the loss deduction was $544,042, and its basis in its LTP interest in 2015 was zero. The IRS contended that the taxpayer's deduction of such losses in excess of its basis was improperly under section 704(d), but the IRS did not disallow any part of the 2014 or 2015 excess loss deduction or issue a Notice of Final Partnership Administrative Adjustment (FPAA) for either year. The IRS argued, however, that the taxpayer was required to decrease its basis in its LTP interest in 2017 to account for the $3,308,767 in excess losses improperly deducted in 2014 and 2015.

The Tax Court agreed with the IRS's position based on the plain wording of section 705(a), which requires a partner to decrease its basis in its partnership interest by the sum of its distributive share of partnership loss "for the taxable year and prior taxable years." The court found that the IRS was simply recalculating the taxpayer's 2017 year-end basis in its LTP interest to account for current-year and prior-year losses that were claimed by the taxpayer and allowed by the IRS. The court defined an allowed deduction as a deduction actually claimed on a return and allowed by the IRS, distinguishing the word from an "allowable deduction," which it defined as one which qualifies under a specific provision of the Code. As such, even though the taxpayer's losses in 2014 and 2015 were improper under section 704(d), they were not disallowed by the IRS and thus must be taken into account under section 705(a) per the court's holding.

The court also rejected the taxpayer's argument that the IRS could not use an FPAA for 2017 to adjust the taxpayer's basis in its LTP interest to account for the 2014 and 2015 excess losses. The court found that it was immaterial that the IRS did not issue an FPAA for 2014 and 2015 or that those years are closed, holding in substance that items from prior closed years may be considered in a TEFRA partnership proceeding to calculate basis in an open year. because section 705(a) requires an annual computation of outside basis, and under the plain language of the statute this requires decreasing outside basis for current-year losses as well as all prior-year losses.

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