

2015

When is an operating arrangement a partnership?

Neil E. Harl

Iowa State University, harl@iastate.edu

Follow this and additional works at: <http://lib.dr.iastate.edu/agdm>



Part of the [Agribusiness Commons](#)

Recommended Citation

Harl, Neil E. (2015) "When is an operating arrangement a partnership?," *Ag Decision Maker Newsletter*: Vol. 15 : Iss. 1 , Article 3.
Available at: <http://lib.dr.iastate.edu/agdm/vol15/iss1/3>

This Article is brought to you for free and open access by the Ag Decision Maker at Iowa State University Digital Repository. It has been accepted for inclusion in Ag Decision Maker Newsletter by an authorized editor of Iowa State University Digital Repository. For more information, please contact digirep@iastate.edu.



When is an operating arrangement a partnership?*

by Neil E. Harl, Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University, Ames, Iowa. Member of the Iowa Bar, 515-294-6354, harl@iastate.edu

A 2010 Tax Court case addressed the informality of a father-son farming operation that had been running for more than three decades. The gist of the controversy was that the father and son shared the income roughly on a 50-50 basis but the father consistently claimed more than 50 percent of the expenses which were used to offset a profitable accounting practice that, in the years in question, generated an average of \$253,365 in Schedule K-1 income.

The case will undoubtedly create heartburn for many such operations characterized by vague and seemingly inconsistent rules for allocation of income and expenses.

What is a partnership?

When the arrangement was initially formed, in 1977, the father did not transfer any interest in the separately owned properties (held in the father's name) to the son and took no steps to clarify their respective interests in the livestock or equipment although the father and son had an understanding that all properties involved in the farming operation would pass to the son at the father's death. By 2004, the first year under scrutiny on audit, the operation had developed into a profitable cattle farming venture.

The father and son argued that the arrangement was a joint venture between two individual proprietorships although they offered little in the way of evidence as to the justification for the unequal allocation of expenses which had varied from year to year. As an example, the father deducted 11.4 percent of the operation's depreciation (including expense method depreciation) in 2004, 79.4 percent in 2005 and 47.2 percent in 2006. Moreover, the arrangement was never committed to writing. The Internal Revenue Service took the position that the arrangement was a partnership with two equal partners and pressed the issue to the point of levying accuracy-related penalties on the father. The regulations, for the years in question, presumed that all partners' interests are equal, on a per capita basis. That regulation was amended, effective for taxable years beginning on or after May 19, 2008 to remove

the presumption, but the amended regulations were not applicable in Holdner.

The Tax Court agreed that the existence of a partnership for federal income tax purposes is a question of federal law, in accordance with a lengthy array of cases. The Tax Court noted that the Internal Revenue Code defines a partnership as "... a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not ... an estate or trust or a corporation."

The court acknowledged that a partnership for federal income tax purposes is basically the same as the definition of a partnership for commercial law purposes but more detailed, although the federal statute controls for determining the existence of a partnership for federal income tax purposes. The Tax Court in Holdner then proceeded to cite approvingly to a 1964 Tax Court decision, *Luna v. Commissioner*, which listed eight factors that are relevant in determining whether an enterprise is a partnership for federal income tax purpose –

- (1) the agreement of the parties and their conduct in executing its terms;
- (2) the contributions, if any, which each party has made to the venture;
- (3) the parties' control over income and capital and the right of each to make withdrawals;
- (4) whether each party was a principal and co-proprietor, sharing a mutual obligation to share losses;
- (5) whether business was conducted in the joint names of the parties;
- (6) whether the parties filed federal partnership income tax returns or otherwise represented to others that they were joint venturers;
- (7) whether separate books of account were maintained for the venture; and
- (8) whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

Interestingly, the Tax Court in the 1964 case refused to

When is an operating arrangement a partnership?, continued from page 5

find that a partnership (or joint venture) existed.

The Tax Court in Holdner found that seven of the eight factors supported the holding that the operation was a partnership for federal income tax purposes and the one remaining factor neither supported nor weighed against the court's finding.

The outcome

The Tax Court held that the arrangement in Holdner was a partnership for federal income tax purposes in the years in question (2004 through 2006) and that the individuals involved were equal partners in the

partnership. It followed that the income, expenses and other partnership items had to be allocated accordingly.

Would the result have been different under the regulations in effect for taxable years beginning on or after May 19, 2008? That would seem to turn on the perceived importance of the presumption in the earlier regulations.

**Reprinted with permission from the August 27, 2010 issue of Agricultural Law Digest, Agricultural Law Press Publications, Brownsville, Oregon. Footnotes not included.*

Updates, continued from page 1

Decision Tools and Current Profitability

The following tools have been added or updated on www.extension.iastate.edu/agdm.

Season Average Price Calculator -- A2-15

Corn Profitability -- A1-85

Soybean Profitability -- A1-86

Ethanol Profitability -- D1-10

Biodiesel Profitability -- D1-15

Returns for Farrow-to-Finish -- B1-30

Returns for Weaned Pigs -- B1-33

Returns for Steer Calves -- B1-35

Returns for Yearling Steers -- B1-35

... and justice for all

The U.S. Department of Agriculture (USDA) prohibits discrimination in all its programs and activities on the basis of race, color, national origin, gender, religion, age, disability, political beliefs, sexual orientation, and marital or family status. (Not all prohibited bases apply to all programs.) Many materials can be made available in alternative formats for ADA clients. To file a complaint of discrimination, write

USDA, Office of Civil Rights, Room 326-W, Whitten Building, 14th and Independence Avenue, SW, Washington, DC 20250-9410 or call 202-720-5964. Issued in furtherance of Cooperative Extension work, Acts of May 8 and July 30, 1914, in cooperation with the U.S. Department of Agriculture. Gerald A. Miller, interim director, Cooperative Extension Service, Iowa State University of Science and Technology, Ames, Iowa.

Permission to copy

Permission is given to reprint ISU Extension materials contained in this publication via copy machine or other copy technology, so long as the source (Ag Decision Maker Iowa State University Extension) is clearly identifiable and the appropriate author is properly credited.