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When Is An Operating Arrangement a Partnership?

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When Is An Operating Arrangement a Partnership?

-by Neil E. Harl*

A 2010 Tax Court case addressed the informality of a father-son farming operation that had been running for more than three decades.[1] 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.[2]

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.[3] 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.[4] As an example, the father deducted 11.4 percent of the operation's depreciation (including expense method depreciation[5]) in 2004, 79.4 percent in 2005 and 47.2 percent in 2006.[6] 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[7] on the father. The regulations, for the years in question, *presumed* that all partners' interests are equal, on a per capita basis.[8] 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*.[9]

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,[10] 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

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any business, financial operation, or venture is carried on , and which is not . . . an estate or trust or a corporation."[11]

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[12] *but more detailed,*[13] although the federal statute controls for determining the existence of a partnership for federal income tax purposes.[14] The Tax Court in *Holdner*[15] then proceeded to cite approvingly to a 1964 Tax Court decision, *Luna v. Commissioner,*[16] 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.[17] Interestingly, the Tax Court in the 1964 case refused to find that a partnership (or joint venture) existed.[18]

The Tax Court in *Holdner*[19] 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*[20] 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.[21]

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.

ENDNOTES

[1] Holdner v. Comm'r, T.C. Memo. 2010-175. See generally 8 Harl, *Agricultural Law* § 60.01[1] (2010); Harl, *Agricultural Law Manual* § 7.03 (2010); 2 Harl, *Farm Income Tax Manual* § 6.01[1] (2010 ed.). See also Harl, "Planning Strategies for the Death of a Partner," 18 *Agric. L. Dig*. 65 (2007); Harl, "Planning for Retirement and Death of a Partner," 17 *Agric. L. Dig*. 145 (2006).

[2] Holdner v. Comm'r, T.C. Memo. 2010-175.

[3] *Id*.

[4] *Id*.

[5] I.R.C. § 179.

[6] Holdner v. Comm'r, T.C. Memo. 2010–175.

[7] I.R.C. § 6662(a), (b)(1).

[8] Treas. Reg. § 1.704-1(b)(3)(i).

[9] Holdner v. Comm'r, T.C. Memo. 2010-175.

[10] E.g., Comm'r v. Culbertson, 337 U.S. 733, 741 (1949).

[11] I.R.C. § 7701(a)(2). See I.R.C. § 761(a), Treas. Reg. § 1.761-1.

[12] Holdner v. Comm'r, T.C. Memo. 2010-175, footnote 18.

[13] *Id*.

[14] Comm'r v. Tower, 327 U.S. 280 (1946).

[15] Holdner v. Comm'r, T.C. Memo. 2010-175.

[16] 42 T.C. 1067, 1077-1078 (1964).

[17] *Id*.

[18] *Id*.

[19] Holdner v. Comm'r, T.C. Memo. 2010-175.

[20] *Id*.

[21] *Id*.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

FEDERAL TAX

CLAIMS. The IRS has issued internal interim guidance on policies and procedures for completing an initial case analysis in Chapter 7, Chapter 11, and Chapter 12 bankruptcy cases. These procedures will be incorporated into Internal Revenue Manual (IRM) 5.9.6, IRM 5.9.8 and IRM 5.9.9. **SB/SE-05-0710-034, July 8, 2010**.

DISCHARGE. The debtor, a CPA, incurred income tax liability for investments in sham employee leasing partnerships. Lawsuits and audit negotiations took several years but eventually resulted in signed stipulations as to the amount taxes owed. Instead of paying the taxes, the debtor continued an affluent lifestyle, including a second residence and luxury vacations. The court held that the tax liability was nondischargeable under Section 523(a)(1)(C) for willfully attempting to evade payment of the taxes. ***In re* Bryen, 2010-2 U.S. Tax Cas. (CCH) ¶ 50,568 (Bankr. E.D. Penn.**