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FCG VALUATION CASE E-FLASH

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Issue 12:12

CITATION:
Randal W. Holdner, Petitioner v. Commissioner of Internal Revenue, Respondent, and William F. Holdner, Petitioner v. Commissioner of Internal Revenue, Respondent
T.C. Memo. 2010-175, Docket Nos. 10367-08, 10375-08, Filed August 4, 2010.

The Tax Court considered whether two individuals working together without a written agreement constituted a partnership, whether the individuals were equal partners, and whether the individual filing tax returns for both was liable for accuracy-related penalties under IRC § 6662.

TAKEAWAY
Disproportionate allocation of income and expense items is permitted if 1) written agreements exist to explain the allocation and 2) income and expense items are allocated in proportion to the ownership interest owned. Because the business in *Holdner* lacked a written partnership agreement, the Tax Court found that disproportionate allocation was impermissible and the accountant (who also was one of the two partners) was negligent by allowing such allocations.

FATHER AND SON OPERATE FARM
William and Randal Holdner (father and son, respectively, and "Taxpayers") jointly operated a family farming business. After Randal graduated from high school, William proposed an agreement in which Randal would handle the day-to-day operations in exchange for a portion of the company's profits. The Taxpayers agreed to split evenly the proceeds from cattle sales and that Randal would have an equity interest. No discussion of the allocation for other income or expense items occurred, and no written agreement was executed between the two. William did not separately transfer interests in the farm's equipment, livestock, or any of the properties titled separately to William.

The Taxpayers jointly purchased as tenants-in-common several properties under land sales contracts in order to expand the farming operation. Taxpayers had another ***unwritten*** understanding that the jointly purchased properties would pass to Randal upon William's death in order for the farming operation to continue unaffected.

Sometime before 2004, the Taxpayers created a bank account for the farm, into which they deposited all proceeds, from which they paid expenses, and from which they both took draws. The Taxpayers also purchased a commercial insurance policy which described the form of business as a partnership. Additionally, the Taxpayers registered the farm as a partnership with the state of Oregon.

ALLOCATION OF INCOME/EXPENSE ITEMS
In addition to his work on the farm, William Holdner was a partner in an accounting practice, for which he filed Schedule K-1, Partner's Share of Income, Deduction, Credits, etc., on his personal income tax return. However, when he filed tax returns for himself and his son between 2004 and 2006, income from the farm was reported on Schedule F, while expenses were shown on Schedule D.

William basically credited himself and son with one-half of the farm's income. However, he deducted most of the farm's expenses on his own tax return, effectively creating a farming loss for himself. William allocated farming expenses in seemingly random amounts bearing no relationship to an ownership percentage.

The IRS examined the Taxpayers' 2004-2006 tax returns and determined that the farm was a partnership for tax purposes, the Taxpayers were equal partners, and income and expense items must be allocated according to ownership interests. As a result of the misstatements, the IRS determined William was liable for accuracy-related penalties under IRC § 6662 for 2004-2006.

CHARACTERISTICS OF A PARTNERSHIP

The Tax Court considered eight factors of a partnership as identified in Luna v. Commissioner, 42 T.C. 1067, 1077-1078 (1964) and noted the Taxpayers:

- agreed to share income from cattle sales, timber sales, and leasing activity;
- contributed capital and labor;
- had equal control over the farm's bank account;
- shared proprietary interest in the farm's profits;
- the farm's name did not suggest sole ownership by either Randal or William;
- held their farm out to their insurer and the state of Oregon as a partnership;
- maintained a separate bank account and maintained meticulous records for the enterprise; and
- exercised mutual control over and responsibility for the enterprise.

Because the farming operation satisfied seven of the eight factors from Luna v. Commissioner, the Court determined it was a partnership for federal tax purposes.

DETERMINATION OF PARTNERS' INTERESTS

Relying on Income Tax Regulations § 1.704-1(b)(3)(ii), the Tax Court considered the following four factors for determining the partners' interests in the farm:

1. relative contributions to the partnership,
2. respective interests in partnership profits and losses,
3. partners' interests in cash flow and other non-liquidating distributions, and
4. right to capital upon liquidation.

Neither of the Taxpayers were able to produce credible evidence indicating factors 1, 2, and 4 should be anything other than 50/50. The only credible evidence produced by the Taxpayers established the fact that they each had equal rights to the farm's bank account and the ability to take withdrawals from the account.

As a result, the Tax Court determined the Taxpayers were equal partners in the farm. In the absence of a written agreement to the contrary, profits, losses, expenses, and other partnership items should be divided accordingly.

IRC § 6662 PENALTIES DUE

The Tax Court determined that as a practicing accountant, William Holdner would have known that his disproportionate allocation of expenses would shelter income from federal taxes. As a result of this knowledge and his failure to allocate farm expenses equally, the Tax Court found William was negligent and liable for accuracy-related penalties under IRC § 6662.

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