19 - Business Arrangement Between Couples Didn’t Rise to Level of a Partnership

White, et ux., TC Memo 2018-102

The Tax Court has ruled that taxpayers, husband and wife, who had a loose business arrangement with another couple, failed to prove the existence of a partnership under the criteria established by the Court's oft-cited Luna case.

Background. A partnership is essentially a conduit which passes through to each partner his or her share of income and deductions generated by the partnership. Thus, the partners, not the partnership, are taxed on the partnership's income. (Code Sec. 701) The partnership only files an information return (Form 1065) showing each partner's distributive share of the partnership income, deductions, gains, losses, etc. Each partner includes his share of these items on his own return. (Code Sec. 702)

A partnership is a business entity with two or more owners (Reg § 301.7701-1(a)(1), Reg § 301.7701-3(a)) who "carry on a trade, business, financial operation, or venture and divide the profits therefrom." (Reg § 301.7701-1(a)(2))

The Tax Court, in Luna, (1964) 42 TC 1067, provided the following eight factors to consider in determining the existence of a partnership for tax purposes:

(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 proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income;

(5) whether business was conducted in the joint names of the parties;

(6) whether the parties filed Federal partnership returns or otherwise represented to IRS or to persons with whom they dealt 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.

Facts. Mr. Marc White was approached by his ex-wife, April Van Patten, about forming a mortgage company. Mr. White and Mrs. Van Patten, along with their respective spouses, Kelly White and Mr. Van Patten, ultimately agreed to work together in the real estate business in late 2010 or early 2011. This business had two separate components under two separate names: Mortgage Lending Services of California was the mortgage lending business, and Homebuyers Resource Center was the real estate transaction business. The couples did not reduce the terms of their business relationship to writing.

The business was run very informally. The couples did not consult or employ any tax professionals. For a time they did employ a bookkeeper who used QuickBooks software to maintain the company's books and records, but as business declined they were unable to pay the bookkeeper. Those Quickbooks files were no longer accessible, and the taxpayers did not call the bookkeeper to testify at trial.

During the 2011 tax year, the taxpayers, Mr. and Mrs. White, withdrew $211,746 from Mr. White's retirement account and used a substantial part of this distribution to support the new business. The Van Pattens did not make similar financial contributions to the business. While Mr. Van Patten testified that he also made capital contributions to the business, the Tax Court did not find this testimony credible. When Mr. White was asked what contributions the Van Pattens made, he responded: "I mean, they really didn't have any money, I mean, to speak of when we all partnered up."

While the taxpayers argued that the couples agreed to an equal division of profits, Mr. White acknowledged at trial that this did not occur. The record showed irregular cash withdrawals by the taxpayers and some payments to the Van Pattens along with commission payments and "draws" to other associates.

Mr. White oversaw office operations, and Mrs. White oversaw the real estate agents, followed up on agents' leads, tracked agents' progress in showing homes, and wrote offers. She also satisfied the requirements necessary to re-establish her real estate license, after which she served as a real estate agent, providing backup support for the other real estate agents and helping show properties herself. Mrs. Van Patten served as the broker of record because she held the required professional licenses. Mr. Van Patten was responsible for marketing, structuring loans, and overseeing loan processing.

The taxpayers' personal checking account was used for the business' banking during the first few months of operation. The Van Pattens explained to Mr. White

that they had had problems with bad checks in a prior business and could not open business bank accounts. Later, a business savings account and a business checking were opened listing “Mortgage Lending Services of California” as the account. The three signatories on these account were Mr. White as president, Mrs. White as treasurer, and Camille Straughn as secretary. And then, a third business checking account was opened with only Mr. White listed as president and secretary.

Later still, Mr. White opened three new business accounts: a business checking account under Mr. White DBA Mortgage Lending Services of CA; a business checking account under Mr. White DBA Homebuyers Resource Center; and a business checking account under Mr. White DBA Mortgage Lending Services, Trust Account. The accounts listed Mr. White as the sole signatory, and the business designation selected for each account was “Sole Proprietorship” with Mr. White listed as the sole proprietor.

The taxpayers controlled the business' funds, used business accounts to pay personal expenses and personal accounts to pay business expenses, and did not maintain books and records tracking these payments. They also used funds from the business accounts to pay expenses for the Van Pattens, such as utility bills and car payments, but aside from most of the mortgage payments for the house where the Van Pattens lived, the record did not include reliable evidence showing how much they paid.

Mr. White explained the arrangement with the Van Pattens with regard to the house where the Van Pattens lived. Under a verbal agreement, he agreed to pay the mortgage on the house (which was in his name) because their credit was bad. The Van Pattens would agree to pay Mr. White and they would take over the mortgage on the house when they could actually qualify for it.

The taxpayers filed joint Forms 1040 (U.S. Individual Income Tax Return) for 2011 and 2012. No Forms 1065, (U.S. Return of Partnership Income) was ever filed for the business. The taxpayers attached Schedules C and Schedules C-EZ (Net Profit From Business) to their 2011 and 2012 Forms 1040. The Schedules C related to Mr. White's shares of the business income and expenses, and the Schedules C-EZ related to Mrs. White's shares.

The Van Pattens reported income for Mr. Van Patten's "Real Estate Marketing" activities and income for Mrs. Van Patten's "Real Estate" activities on their 2011 Schedules C. On their 2012 Schedules C the Van Pattens reported income for Mr. Van Patten's business activities and income for Mrs. Van Patten's business activities. Mrs. Van Patten's 2011 Wage and Income Transcript (which showed data from information returns IRS received such as Forms W-2, 1099, 1098) indicated that she was issued six Forms 1099-MISC (Miscellaneous Income)

related to her real estate activities: five forms were issued to her, and one was issued to her on behalf of Mortgage Lending Services of California. Mrs. Van Patten's 2012 Wage and Income Transcript indicates that she was issued four Forms 1099-MISC related to her real estate: two forms were issued to her, one was issued to her on behalf of Homebuyers Resource Center, and one was issued to her on behalf of Mortgage Lending Services.

The taxpayers did not reconcile Mrs. Van Patten's Forms 1099-MISC with their business gross receipts. The Court could identify only two Form 1099-MISC payors from Mrs. Van Patten's Wage and Income Transcript in IRS's bank deposits analysis. The Court could not reconcile the deposits with the bank statements in the record. The gross receipts that the Van Pattens reported on their Schedules C exceeded the total gross receipts reported to Mrs. Van Patten on her Forms 1099-MISC. The taxpayers never explained how the payments reported to Mrs. Van Patten were transferred to the business.

The issue. Whether, as the taxpayers asserted, the couples' business was properly classified as a partnership for tax purposes. If that were the case and the business was a partnership, the taxpayers would be taxable or only their distributive shares of the partnership's income.

Court's conclusion. Considering the record as a whole, applying the Luna factors, and considering the inconsistencies in the record, the Tax Court concluded that the business was not properly classified as a partnership for tax purposes. While the record indicated that there was some sort of relationship, the record didn't support a conclusion that the business was a partnership. The Court understood that the taxpayers were trying to make ends meet in a challenging time, but it found that their explanations for the inconsistencies between their story and the evidence had far too many gaps.

The Court analyzed the Luna factors and found seven factors supported a finding that a partnership didn't exist while one factor supported a contrary conclusion:

Agreement of parties and conduct in executing terms. A partnership agreement may be entirely oral and informal, but the parties must demonstrate that they complied with its terms. While the couples may have agreed orally to an equal division of profits, Mr. White acknowledged that this division did not occur. The taxpayers withdrew varying sums of money from the business at irregular intervals. The Van Pattens (who could not withdraw money directly) received irregular payments in amounts different from the withdrawals and payments by the taxpayers. The Court found that it could not count the taxpayers' mortgage payments for the home occupied by the Van Pattens as evidence of the Van Pattens' right to partnership profits. While the taxpayers argued that the Van Pattens owned the home, the taxpayers deducted the interest payments on their own joint Forms 1040. And while the taxpayers pointed out that the Van Pattens' returns showed that the Van Pattens already reported their shares of the

business income, the taxpayers never established that the Van Pattens did not receive income from other sources. Further, the taxpayers never explained how payments reported on the Van Pattens' Forms 1040 (and on Forms 1099-MISC issued to Mrs. Van Patten) made their way into the business bank accounts or were accounted for otherwise. This factor weighed against a finding that a partnership existed.

Parties' contributions to the venture. The taxpayers withdrew $211,746 from Mr. White's IRA and used these funds, in part, to capitalize the business. There was no credible evidence that the Van Pattens made any capital contributions. However, the record suggested that the taxpayers and the Van Pattens each performed services related to the business. This factor weighed for a finding that a partnership existed.

Control over income and right to make withdrawals. The taxpayers argued that the Van Pattens had equal rights to withdraw funds from the accounts, but the credible evidence before the Court indicated that the taxpayers had sole financial control. The taxpayers were the signatories on all of the business accounts throughout the business' existence; the Van Pattens never were. While Camille Straughn also had signature authority for one of the initial accounts, nowhere in the record did the taxpayers allege that Ms. Straughn was acting on behalf of the Van Pattens. While the record showed that the taxpayers made payments to or on behalf of the Van Pattens, no evidence showed that the Van Pattens had rights to withdraw funds from the accounts aside from Mr. White's testimony that the Van Pattens had debit cards. But the account statements did not indicate who made withdrawals, nor did the taxpayers tie any specific expenditures to the Van Pattens. While the Van Pattens received some payments related to the business, and the taxpayers paid the mortgage for the Van Pattens at least for part of the years at issue, this evidence was not enough to conclude that the Van Pattens had joint control over the business' income. This factor weighed against a finding that a partnership existed.

Co-proprietor or nonpartner relationship. IRS asserted that the Van Pattens had a separate business and were independent contractors who were paid commissions. The taxpayers asserted that the compensation of the couples was contingent on the proceeds from the business and they did not have fixed salaries. The record indicated that the Van Pattens played a role in the business, but the evidence was not sufficient to show that their role was co-proprietors rather than independent contractors. For example, while business owners may agree to compensate key employees with a percentage of business income, or brokers may be retained to sell property for a commission based on the net or gross sale price, these arrangements may result in a division of profits; but neither constitutes a partnership unless the parties become co-proprietors. The record showed that payments to independent contractors were labeled commission payments and draws, like payments made to the Van Pattens. The only evidence that the Van Pattens received payments more akin to a partner's

share than an independent contractor's commission or draw was the taxpayers' and the Van Pattens' uncorroborated testimony. This factor weighed against a finding that a partnership existed.

Whether business was conducted in joint names. As the business' bank records reflect, the accounts were held in either Mr. White's name alone or the taxpayers' names together and included the names of the businesses. The Van Pattens were not listed on any of the accounts. Further, the taxpayers designated the business as either a sole proprietorship or a corporation, not a partnership. And it appeared that the Van Pattens had separate business bank accounts. Mrs. Van Patten's check showed "April Lynn Van Patten DBA Mortgage Lending Services of California (a Sole Proprietorship)" at least at some point in the business relationship. And another check to Mortgage Lending Services listed Camille Straughn "DBA The Van Patten Group." These checks suggested that the couples both treated the business as their own sole proprietorships, not a joint enterprise, not just on their Forms 1040, but also to financial institutions (and potentially check recipients). This factor weighed against a finding that a partnership existed.

Filing of partnership returns or representation of joint venture. As the taxpayers acknowledged, they did not prepare and file a Form 1065 for their business for either tax year at issue. Instead, they reported the income and expenses on their Schedules C and C-EZ. The taxpayers asserted that they represented to others that they were joint venturers and informed IRS during their examination that they operated a partnership. IRS disputed this characterization, alleging that the taxpayers characterized transfers from the Van Pattens as loan repayments. The taxpayers' uncorroborated testimony could not overcome their reporting of income and expenses on their returns and the bank account records in evidence. This factor weighed against a finding that a partnership existed.

Maintenance of separate books and accounts. The taxpayers contended that they used QuickBooks to maintain separate books and records at the entity level. But, the taxpayers failed to produce any evidence that separate books and accounts were maintained other than their uncorroborated testimony. The business bank accounts were held in the taxpayers' names (either Mr. White or both Mr. and Mrs. White). The taxpayers also admitted that they used business accounts for personal expenses and personal accounts for business expenses. This factor weighed against a finding that a partnership existed.

Exercise of mutual control and assumption of mutual responsibilities. The taxpayers and the Van Pattens testified that they each assumed separate roles in the real estate and mortgage activities, and the record supported a finding that they had a business relationship in which they had different roles. But the fact that they may have performed separate functions did not convince the Tax Court that they exercised "mutual control" and "mutual responsibilities" indicative of a

partnership, notwithstanding their conclusory testimony. This factor weighed against a finding that a partnership existed.

Alternate conclusion. The Tax Court concluded that even if it were to conclude that a partnership existed, it determined that it had no reliable evidence of the partnership's total receipts on which it could base an allocation of income different from the amounts IRS calculated using its bank deposits analysis. Accordingly, the Court held that the taxpayers had unreported Schedule C gross receipts of $42,985 and $121,053 for the 2011 and 2012 tax years, respectively.