



Home is Where the Partnership Isn't
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You Win Some, You Lose Some

We haven't seen a lot of case law regarding the post-1997 §121 exclusion on the gain on sale of a principal residence, so a recent case is of interest to look at both how to defend the exclusion and how you can foul it up—as these taxpayers both successfully defended an IRS challenge that they did not use the property in question as their personal residence and managed to lose the benefit of the exemption because it turned out they were not (at least per the title) the owners of part of the property—a partnership was found to be the true owner, and partnerships don't qualify for the §121 exclusion.

The case in question is the one of *Farah v. Commissioner*, T.C. Memo 2007-369.

Background of the Case

When a taxpayer had more than one residence, the question of which residence is the taxpayer's principal residence can become uncertain. In fact, this question is one which has been litigated before, making up one of the other few cases we have on Section 121—

the case of *Guinan v. U.S.*, 2003-1 USTC ¶50475. Like the taxpayers in *Guinan*, the Farahs had two different residences. The Hagarstown, Maryland residence was purchased by the taxpayers in 1977. Dr. Farah had opened a pediatric practice in Hagarstown in 1976 and was appointed to the medical staff of a hospital in Hagarstown the same year.

In October of 1989, Dr. and Mrs. Farah purchased another house in Berlin, Maryland with the intent to use it as a summer house and eventually their retirement home. Over time they improved the property and, in 1991, purchased an unimproved lot adjacent to their residence to use for the residence. On the advice of counsel, they formed the J. Ramsay Farah Family Partnership to purchase the property. They were advised that by having the property held with his children in the partnership, it would make it more difficult for a creditor to attach should a liability arise from his medical practice.

The partnership documents indicated that Dr. and Mrs. Farah each owned a 35% interest in the partnership, with each of their two children holding 15% interests. Though Dr. and Mrs. Farah signed the partnership agreement, neither child signed the agreement, nor were any contributions made by the children to the partnership. The partnership did not register as a business entity with the state of Maryland and did not obtain an employer identification number.

Relocation

In 1997, the taxpayers' daughter was accepted as a freshman at Salisbury State University. Per the court, she required "heightened parental supervision and support" and her parents planned to move with her to the Berlin house. Dr. Farah sold his practice in Hagarstown and closed his practice in Boonsboro.

Mrs. Farah moved to Berlin in July of 1997 to be with her daughter. She drove her daughter to school and to part time jobs. Both Mrs. Farah and her daughter received medical treatments, including surgeries, in Salisbury, Maryland, near the Berlin home. The Farahs also discontinued their memberships in a number of social and community organizations in Hagarstown.

Dr. Farah began working part-time for Sierra Military Health in Baltimore in 1998 and later that year was promoted to full medical director working in quality assurance. He was required to work 3 days a week in the Baltimore office, location that is 75 miles from the Hagarstown residence and 138 miles from Berlin. He was also required to travel extensively to various clinics in an area from Maine to Northern Virginia. He continued in this position until March of 2005.

Until October of 1998, Dr. Farah served as medical director at a facility in Sabillasville, Maryland. His service agreement was terminated in October 1998 because he no longer lived within 20 miles of the facility. The Hagarstown house was 17 miles from that facility, while the Berlin house was more than 200 miles away.

Although he travel a lot, Dr. Farah returned to Berlin as often as he could at the end of a workday, though he did use the Hagarstown house as well. However, he was always in Berlin on weekends and other non-working days to be with his family.

Dr. Farah returned to the Hagarstown house more often than Mrs. Farah did. He returned at least once a month to collect bulk mail sent there. However, they used the Hagarstown house as their mailing address, on their voter registrations, vehicle registrations, drivers licenses and on all income tax returns. All bills associated with the Berlin house were sent to Hagarstown. Water and electricity use remained constant at the Hagarstown house from July 1997 through January 2007.

The taxpayers (now former) daughter-in-law (Christina) lived in the Hagarstown house beginning in 1996. Because her husband was, at times, abusive, the taxpayers allowed her to stay in the Hagarstown house rent free to provide a safe location for herself and the Farah's grandchild. Christina often forwarded the mail from the Hagarstown house to Berlin. When she was not in Hagarstown, their son would stay there with his friends and forward the mail.

Sale of Berlin Properties

In January 2001 Mrs. Farah developed a medical condition that was felt could best be treated by facilities nearer the Hagarstown residence. In 2001 both properties were listed for sale as a single unit and in the Fall the taxpayers moved most of their furnishings back to Hagarstown. Both properties were sold on October 27, 2001 for a total of \$1,300,000.

The settlement company prepared two separate HUD-1 closing documents, one for each property. The allocation of the price was shown as \$500,000 for the lot and \$800,000 for the main residence, though this allocation was not negotiated between the parties (in fact, Dr. and Mrs. Farah were not aware there would be two documents until the date of the closing). The settlement sheet showed the partnership as the owner of the lot, and no change of ownership in the lot had been recorded for it since its original purchase.

On their 2001 return, the taxpayers reported only \$600,000 as a sales price for their home, and reported a basis of \$600,000 to offset it. The sale of the lot was not reported on their tax return. The IRS examined their return, and ended up adjusting their income to report a \$660,371 gain on the sale of the Berlin home and the adjacent lot.

In order to be able to exclude a gain on sale, the taxpayers must be able to show that they meet both prongs of the following test under §121(a):

(a) Exclusion

Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been *owned* and *used* by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.

Both of those issues would be involved in deciding this case.

Was Berlin the Principal Residence?

The first issue was whether the Berlin residence was truly their principal residence—that is, did they meet the use requirement of §121(a). Regulation §1.121-2(b) contains provisions governing determining what is a principal residence. The general rule is found under Reg. §1.121-2(b):

(1) In general.

Whether property is used by the taxpayer as the taxpayer's residence depends upon all the facts and circumstances. A property used by the taxpayer as the taxpayer's residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)). Property used by the taxpayer as the taxpayer's residence does not include personal property that is not a fixture under local law.

To give some more guidance to what are the “facts and circumstances” we need to look to the more detailed description at Reg. §1.121-1(b)(2) which provides:

(2) Principal residence.

In the case of a taxpayer using more than one property as a residence, whether property is used by the taxpayer as the taxpayer's principal residence depends upon all the facts and circumstances. If a taxpayer alternates between 2 properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence, include, but are not limited to --

- (i) The taxpayer's place of employment;
- (ii) The principal place of abode of the taxpayer's family members;
- (iii) The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;
- (iv) The taxpayer's mailing address for bills and correspondence;
- (v) The location of the taxpayer's banks; and
- (vi) The location of religious organizations and recreational clubs with which the taxpayer is affiliated.

The first issue is whether the Berlin location was the taxpayers' principal residence during the year in question. The Court quickly disposes of Mrs. Farah's residency, noting

that she rarely went back to the Hagerstown house from the time she relocated to Berlin until the Berlin house was put on the market for final sale.

However, Dr. Farah was a bit more difficult since, for him, a number of factors came down on the side of the Hagerstown residence. He had a job that required him to work in a location that was significantly closer to the Hagerstown residence than the Berlin one three days a week. He also worked ½ day a week in a clinic that also was significantly closer to the Hagerstown residence than to the one in Berlin. However, there was nothing on the record to show where Dr. Farah stayed while working in Baltimore, but the court found that regardless it seemed clear he spent more time in Berlin than Hagerstown during the period in question.

But time spent is not necessarily an absolute factor—if other factors indicate that a different residence was the principal residence then the fact that he spent more time in Berlin might not be found to be sufficient to count that as the principal residence.

The IRS was particularly concerned about the following factors in arguing that Dr. Farah's residence was not in Berlin:

- His jobs during the period in question were significantly closer to the Hagerstown residence than the one in Berlin
- The consistent level utility bills both before after the date of the move to Berlin suggest Dr. Farah was living there
- The Hagerstown address was used for all of the following purposes
 - Income tax returns
 - Driver's licenses
 - Vehicle registrations
 - Voter registrations
- They did not affiliate with any social organizations in the Berlin area

However, the Tax Court found none of those reasons persuasive for various reasons. The court notes that Dr. Farah was forced to give up one position specifically because his residence was no longer within 20 miles of the Victor Cullen Academy—a distance that was no an issue if he lived in Hagerstown. As well, other evidence showed Dr. Farah abandoned his own practice in that area and gave up privileges at the hospital around the time of the move to Berlin, both consistent with a true change of residence.

The utility bills could be explained by the occupation of the residence by other individuals, occupation that was shown in the case. While the utilities lead to conclusion someone was living there, the evidence could explain that fact by simply allowing for occupancy by other individuals known to have resided in that residence at various points during the period in question.

The Court believed the taxpayers' explanation that they did not change their address for the various items listed because they wanted to maintain a consistent appearance with Dr. Farah's various professional and business activities—he had used the Hagerstown address as his business address since 1980. They did not change the address on their tax return, driver's licenses and auto registrations because they felt it didn't make any real difference and they wanted all of their mail to go to one location.

They did not join social organizations in Berlin because of Dr. Farah's heavy travel schedule and Mrs. Farah's need to care for her daughter meant they simply didn't have the time to have the same level of involvement they had in Hagerstown and, the Court noted, they did remove themselves from those organizations in Hagerstown in any event, so it wasn't as if they remained active in social organizations there.

For these reasons, the Court concluded that the taxpayers did have the Berlin residence as their principal residence for the 2 out of 5 year period required under Section 121.

The Problem of the Title

However, the next issue would not break as well for the taxpayers. The fact that the lot (referred to as the South Point Road Lot in the opinion) was a separate lot isn't itself a problem. Reg. §1.121-1(b)(3)(i) allows for combining adjacent properties owned by the taxpayer:

- (3) Vacant land
- (i) In general.
- The sale or exchange of vacant land is not a sale or exchange of the taxpayer's principal residence unless --
- (A) The vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence;
- (B) The taxpayer owned and used the vacant land as part of the taxpayer's principal residence;
- (C) The taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of section 121 within 2 years before or 2 years after the date of the sale or exchange of the vacant land; and
- (D) The requirements of section 121 have otherwise been met with respect to the vacant land.

The requirements of Reg. §1.121-1(b)(3)(i)(A) and (C) are met without question under the facts of the case, given the Court decision earlier in the case that the Berlin dwelling unit was the taxpayers' principal residence. It's also clear the taxpayers used this property as part of their principal residence—but the other prong of the test at Reg. §1.121-1(b)(3)(i)(B) is the issue in question. Based on the fact it was titled in the partnership's

name, the IRS held that no exclusion was available under §121 since a partnership is not an entity listed at Reg. §1.121-1(c)(3) as one eligible to be treated as ownership by the individual for qualification under Section 121 (those eligible are grantor trusts and disregarded entities).

The taxpayers don't dispute that ownership by a partnership is fatal to qualification for the §121 exclusion. Rather they argue that either:

- Since the partnership was never fully implemented, it should be disregarded and they should be treated as the owner directly *or*
- The partnership distributed the property to them in 1992 and therefore they were the owner of the property.

The Court notes that the Farahs are asking the Court to apply the substance over form doctrine in this case, since all recorded documents show both that the owner of the property was the Family Partnership and that the Family Partnership was also the seller of the property. The Court observes that this is going to be a tough position for the Farahs, as those who chose the form of the transaction, to be able to sustain. The Court explains:

To prevail, the taxpayer must provide objective evidence that the substance of the transaction is in accord with the position argued by the taxpayer rather than the form set forth by the relevant documents. *Id.* at 541. Furthermore, for substance, as opposed to form, to control the tax consequences of a transaction, the taxpayer must establish the claimed substance of the transaction under a heightened burden of proof. *Norwest Corp. v Commissioner*, 111 T.C. 105, 140, 145 (1998); *Ill. Power Co. v. Commissioner, supra* at 1434. The strong proof standard requires the taxpayer to present more than a preponderance of the evidence in support of his characterization of the transaction. *Ill. Power Co. v. Commissioner, supra* at 1434 n.15.

The taxpayers argued that since their children did not sign the partnership agreement, the children made no contributions to the partnership, the partnership did not register with the state and did not obtain an employer identification number that it should be disregarded as the owner of the property. However, the Court noted that they conceded the partnership had been formed and that it was the purchaser of the South Point Road lot.

The court noted that Maryland law would control whether this was truly a partnership. It found that a valid partnership can be created by gifting interests and the court notes that the involvement of their minor children was crucial to the very reason they had gone to the trouble of drafting a partnership agreement. The Court also found that the lack of registration with the state of Maryland and the failure to obtain an employer identification number were not fatal to a finding that this was a partnership. As well, until the IRS issued a Notice of Deficiency the taxpayers had never claimed that the owner of the lot was any entity other than the Family Partnership. Thus the Court found that the partnership could not be ignored.

In 1992 the taxpayer refinanced the loans on the Berlin property and that the lender forced them to transfer the property into their own names. They presented a document that showed a transfer of ownership of the lot to them as tenants by the entirety.

However, there are a few problems with this view. First, the Court notes that the document showing a transfer of ownership was never recorded. Property tax bills continued to be issued in the name of the partnership. No mortgage remained on the South Point Road lot once the refinancing was completed, so there would seem to be no reason why the mortgage company would have asked for a retitling-and, more importantly, if they did insist on that it seems highly unlikely they would not have required the change of ownership to be recorded.

The Court then deals in the end with whether the recorded ownership controls. The Court notes that ownership of property can be separated from the title of the property—so they could be the owners of the property. However, the Court notes that recorded titles are not lightly disregarded, and specifically in this case notes:

Petitioners had approximately 10 years in which to record the change in ownership of the South Point Road lot, but they did not. Petitioners contend they had been the owners of the lot since 1992. However, when selling the property they listed the Family Partnership as its owner. It was not until petitioners realized ownership of the property through the Family Partnership produced adverse tax consequences that they held themselves out as the owners of the property. Petitioners were free to organize their affairs as they chose; nevertheless, having done so, they must accept the tax consequences of their choices, whether contemplated or not. See *Commissioner v. Natl. Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974).

The Court holds that the taxpayers were not the owners of the property, but rather held a 70% interest in a partnership that owned the property and thus were taxed on 70% of that gain (so 70% of \$278,962, or \$195,273). Their children would have been taxable on the remainder of the gain—but, obviously, that case is not the one before the Court at this time.

Penalties

The IRS asserted that the taxpayers, in addition to any tax due, owed a penalty under §6662(a) of 20% for negligence or disregard of the rules or regulations. The taxpayers argued no such penalty should be due, because they had reasonably relied upon their preparer to prepare the return. The Court notes that to make use of that exception, the taxpayers have to show both that they provided the preparer with all relevant information and that the preparer was an apparently competent professional.

Given that the taxpayers claimed the proper treatment was the full \$1,300,000 sale represented property owned by them, the Court found a problem. It noted:

Petitioners further argue that they provided their return preparers with all their raw financial data. Petitioners' 2001 return listed the amount realized on the sale of their residence as \$600,000 and the adjusted basis as \$600,000. Neither of these numbers is accurate. The gross proceeds were \$800,000, the net proceeds were \$752,582, and the adjusted basis was either \$597,054 or \$647,054. Furthermore, the return did not report any amount with respect to the \$500,000 of gross proceeds received from the sale of the South Point Road lot. Considering these major errors and omissions, either petitioners failed to provide their preparers with the necessary information, or the preparers lacked the expertise to properly file a Federal income tax return.

Their own argument at trial essentially became the Court's reason for why they could not escape the penalty—because their return was not prepared in accordance with that very position, nor any other that seemed to make sense given the data. As the court notes, either the preparer never had access to all of the information or he/she was grossly incompetent—so much so that the Farahs should have made note of that fact.

Lessons

On its face, this case shows that, as noted before in earlier podcasts, the taxpayer is going to most often be stuck with the results of the form of a transaction—the “substance over form” argument is a lot easier to win if you don't have control over the form all along. We also need to remember that tax and non-tax issues are interrelated—and that the form used to hold a residence can have significant implications when the property is sold.

But it's also instructive for the very reason that the case came to the IRS's attention. While we cannot use “audit lottery” positions on a tax return, we also need to be aware of those items that will bring a return to the IRS's notice.

In this case, it seems likely that the issue that caused the return to surface at all was the fact that while the IRS had reported proceeds from the sale of \$800,000 or more in 1099s with the taxpayer's ID numbers on it, the taxpayer only reported a sales price of \$600,000. Given that the partnership had no EIN, it seems likely (though not mentioned in the case) that the 1099 for both sales had the taxpayers' social security numbers listed as the recipient. Thus, the IRS computer was staring at between \$200,000 and \$700,000 worth of apparently unreported income—a big enough difference to warrant following up on.

The use test was one the taxpayers won outright, but I suspect the IRS refused to give in on that one largely because the taxpayers lost credibility in the IRS's eyes when they ended up giving what became a shifting story on who was the owner of that extra lot, as well as the interesting story regarding the supposed requirement that the lot's ownership be transferred for a refinancing, but the mortgage company didn't require that fact to be recorded. Thus the IRS simply didn't believe the taxpayers when they brought forth evidence that they truly had been using the Berlin home as their principal residence.