OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated April 29, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Husband =
Wife =
Franchise =
Franchisor =
Business B =
Year 1 =
Year 2 =
Year 3 =
Year 4 =

ISSUES:

(1) Whether Husband may deduct in Year 3 50 percent of the losses on the Franchise, a trade or business he embarked upon jointly with Wife while they were still married, on the theory that he had a community property interest in the Franchise.

(2) Whether a partnership existed between Husband and Wife in connection with the Franchise that would enable him to claim 50 percent of the losses of the Franchise in the year at issue.

CONCLUSIONS:

(1) Notwithstanding the applicable community property provisions of state law, I.R.C. § 66(a) operates to deny Husband a deduction for 50 percent of the losses sustained.

(2) The facts are insufficient to determine whether a partnership existed.

FACTS:

According to your request for advice, the following are the relevant facts.

Husband and Wife were married for a number of years. At all times during their marriage, and up to the present, they resided in California.

In the spring of Year 1, Husband and Wife obtained the Franchise from the Franchisor. In the same year, they negotiated a lease for space in which to operate the Franchise. They also obtained equipment necessary to operate the Franchise. They financed the Franchise through a second mortgage on their home.

Husband and Wife never executed a formal partnership agreement in connection with the Franchise. They also never filed any partnership returns.

Husband and Wife were also joint investors in Business B.

Husband and Wife separated later in the summer of Year 1, several months after they obtained the Franchise. Husband moved out of their residence at that time. Although Husband temporarily resided at the residence during one or two weekends in the fall of that year, by the beginning of the next calendar year he had ceased visiting the residence.

In the meantime, by late summer of Year 1, the Franchise had begun hiring personnel. Wife managed and operated the Franchise without Husband's assistance. By late Year 1 or early Year 2, the Franchise was open for business.

Husband contributed capital to the Franchise; the last contribution was made in February of Year 2. About two weeks before Husband made the last contribution, Husband and Wife entered into Agreement One. Agreement One entitled Husband to receive weekly accounting reports, weekly national reports from the Franchisor, and monthly expenditure reports. It also gave him the option of meeting monthly with Wife and the managers of the business. It also gave him certain visitation rights in connection with his daughter's presence at the business. Under Agreement One, Wife retained substantially all of the management and control of the Franchise.

In April of Year 2, Husband and Wife executed Agreement Two. Agreement Two states in relevant part, "Wife to decide whether to accept husband's offer to trade stock in [Business B] for [the Franchise] within 60 days." According to your request, Wife believes that this agreement gave her complete control of the Franchise, and you have deemed admissions that this is so. Wife believes Agreement Two provided for her to compensate Husband for his past contributions of capital to the Franchise and she would in turn give Husband stock in Business B.

According to Wife, on the date Agreement Two was executed, Husband and Wife agreed to treat the Franchise as Wife's separate property. After the date Agreement Two was executed, Husband provided no personal, managerial, or financial services to the Franchise.

In December of Year 1, Husband and Wife filed for divorce. In April of Year 3, they were divorced. As a result of the divorce proceedings, Wife was awarded the Franchise. The awarding of the Franchise was reflected on a Judgment on Reserve Issues entered in February of Year 4. The Judgment also provided that stock in Business B would be divided in two between the parties; nothing in the Judgment shows that there is a tie-in between Husband's stock and the Franchise. Husband contends that the Judgment implies he was still a co-owner of the Franchise until the signing of the Judgment. Wife, on the other hand, believes she became the sole owner of the Franchise when Agreement Two was executed and the Judgment is only a "balance sheet dividing the property."

[redacted]

The divorce court ordered Husband and Wife to file a joint federal income tax return for Year 2.

During the divorce proceedings, Husband obtained an income and expense statement on the Franchise from Wife. Husband used the income and expense statement as his sole source for completing his Schedule C for the Franchise for Year 3, on which he claimed the loss that is at issue here.

LAW AND ANALYSIS

Issue One

California is a community property state. "Except as otherwise provided by law, all property, real or personal, wherever situated, acquired by a married person during the marriage while domiciled in this state is community property." Cal. Fam. Code § 760. The statutory presumption that property acquired during a marriage is community property is a strong one and is even stronger where the property was acquired with community funds. Katz v. United States, 382 F.2d 723, 728 (9th Cir. 1967).

Here, the property at issue, the Franchise, was acquired during the marriage. It was also acquired with community funds, e.g., the proceeds of a second mortgage on Husband and Wife's marital residence. Accordingly, there is a strong presumption that the Franchise was community property and remained so until the marriage was dissolved and the Franchise was awarded to Wife under the terms of the Reserve Judgment. Accordingly, absent the operation of section 66(a), which will be discussed below, Husband would have a strong argument that he was a co-owner of the Franchise in the year at issue and therefore was entitled claim to 50 percent of the losses on his Schedule C.[1]

Section 66(a), however, provides for the treatment of community income where the spouses are living apart. It applies where (1) two individuals are married to each other at any time during the calendar year; (2) the two individuals live apart at all times during the year and do not file a joint return for the year; (3) one or both of the individuals have earned income for the year which is community income; and (4) no portion of the earned income is transferred (directly or indirectly) between the spouses before the close of the calendar year. If all of these criteria are met, then any community income of the individuals for the calendar year is treated according to the rules of section 879. As you note in your request for advice, all of these criteria have been met. Thus, the rules of section 879 apply.

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[1] We note that Section 771 of the California Family Code provides as follows: "The earnings and accumulations of a spouse and the minor children living with, or in the custody of, the spouse, while living separate and apart from the other spouse, are the separate property of the spouse." We do not think this provision is relevant here, since the issue revolves not around the earnings of either spouse, but the ownership of a business and its effect upon the income of the spouses for tax purposes.

Section 879(a)(2) provides that "[trade or business income, and a partner's distributive share of partnership income, shall be treated as provided in section 1402(a)(5)." Under section 1402(a)(5) if "any of the income derived from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income, all of the gross income and deductions attributable to such trade or business shall be treated as the gross income and deductions of the husband *unless the wife exercises substantially all of the management and control of such trade or business, in which case all of such gross income and deductions shall be treated as gross income and deductions of the wife..."* (emphasis added). According to the facts as you present them, Wife "retained substantially all of the management and control" of the franchise after Agreement One was executed. You also state that after Agreement Two was executed, Husband "provided no personal, managerial, or financial services" for the Franchise. Section 1402(a)(5), is precisely on point. Furthermore, the Tax Court, in interpreting section 1402(a)(5), has stated "if the income derived from a trade or business, other than one carried on by a partnership, is community property, all of the gross income and deductions attributable to such trade or business shall be treated as attributable to the party exercising substantially all of the management and control of such trade or business." Tolotti v. Commissioner, T.C. Memo. 1987-13. See also Webb v. Commissioner, T.C. Memo. 1996-550; Klinger v. Commissioner, T.C. Memo. 1987-46. Thus, under section 1402(a)(5), which relates back to section 66(a) through section 879, Wife's exercise of "substantially all of the management and control" of the franchise would entitle her to claim the business's deductions, in this case the loss.

Furthermore, the regulations under section 879 and section 1402 reinforce this conclusion. Treas. Reg. § 1.879-1(a)(3) provides as follows:

> If any income derived from a trade or business carried on by the husband and wife is community income for the taxable year, all of the gross income, and the deductions attributable to the income, shall be treated as the gross income and deductions of the husband. *However, if the wife exercises substantially all of the management and control of the trade or business, all of the gross income and deductions shall be treated as the gross income and deductions of the wife.*

(Emphasis added). The regulation goes on to provide

> The term "management and control' means management and control in fact, not the management and control imputed to the husband under the community property laws of a state, foreign country or possession of the United States. For example, a wife who operates a pharmacy without any appreciable collaboration on the part of a husband is considered as having substantially all of the management and control

> of the business despite the provisions of any community property laws of a state, foreign country, or possession of the United States vesting in the husband the right of management and control of community property. *The income and deductions attributable to the operation of the pharmacy are considered the income and deductions of the wife.*

(emphasis added). See also Treas. Reg. § 1.879-1(a)(7), Example (2)(b).

The regulations under section 1402 contain essentially the same provisions as Treas. Reg. § 1.879-1(a)(3). Treas. Reg. § 1.1402(a)(8) provides as follows regarding community income:

> If any of the income derived by an individual from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income, all of the gross income, and the deductions attributable to such income, shall be treated as the gross income and deductions of the husband *unless the wife exercises substantially all of the management and control of such trade or business, in which case all of such gross income and deductions shall be treated as the gross income and deductions of the wife*. For purposes of this special rule, the term "management and control" means management and control in fact, not the management and control imputed to the husband under the community property laws. For instance, a wife who operates a beauty parlor without any appreciable collaboration on the part of her husband will be considered as having substantially all of the management and control of such business despite the provision of any community property law vesting in the husband the right of management and control of community property; *and the income and deductions attributable to the operation of such beauty parlor will be considered the income and deductions of the wife.*

(emphasis added).

Both regulations are precisely on point. The trade or business at issue here, the Franchise, is at least presumed to be community property. Wife exercised substantially all of the management and control of the business, with no "appreciable collaboration" on the part of Husband. Thus, under both regulations, Wife and not Husband is entitled to claim the loss applicable to the Franchise in the year at issue.

Accordingly, we conclude that section 66(a), in conjunction with section 879 and section 1402(a)(5), denies Husband a deduction for 50 percent of the loss sustained by the franchise.

Issue Two

The term “partnership” includes 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, within the meaning of the Internal Revenue Code, a trust or estate or a corporation. I.R.C. §§ 761; 7701(a)(2). A partnership agreement may be oral or written. Treas. Reg. § 1.761-1(c). Whether parties engaged in a partnership is a question of fact to be determined from all of the existing circumstances. Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964); Ryza v. Commissioner, T.C. Memo. 1977-64. The most important factor is whether the parties intended to, and did in fact, join together for the present conduct of an undertaking or enterprise. The following factors, none of which is conclusive, are evidence of this intent:

1. the agreement of the parties and their conduct in executing its terms;

2. the contributions, if any, that each party makes to the venture;

3. control over the income and capital of the venture and the right to make withdrawals;

4. whether the parties are co-proprietors who share in net profits and who have an obligation to share losses; and

5. whether the business was conducted in the joint names of the parties and was represented to be a partnership.

Commissioner v. Culbertson, 337 U.S. 733, 742 (1949); Commissioner v. Tower, 327 U.S. 280 (1964); Luna, 42 T.C. at 1077-78.

The fact that a partnership return was not filed is not determinative. Powell v. Commissioner, T.C. Memo. 1967-32.

It is unclear from the facts provided if Agreement Two was an option to enter into the proposed exchange of stock for the interest in the Franchise or set forth the parties’ actual agreement to the exchange. This should be confirmed.

Agreement Two indicates that Wife would transfer her interest in Business B to Husband in exchange for Husband’s interest in the Franchise. Subsequent to the agreement, Wife received complete control of the Franchise. To the extent the agreement was an option to enter into the proposed exchange, additional facts should be obtained that would support a finding that the parties opted to execute the exchange. To the extent the agreement was in fact entered into, Husband did not provide personal, managerial, or financial services for the Franchise, and Wife maintained control over the income and capital of the Franchise and had the right to make withdrawals. It should be confirmed that Husband did not have any control over the income of the Franchise. In addition, the terms of the agreement should be reviewed to determine if it established who was to share in the profits and losses of the Franchise.

The awarding of the Franchise to Wife pursuant to the Judgment on Reserve Issues is not determinative of whether the Franchise was operated as a partnership prior to that time. Rather, whether a partnership existed must be determined from the facts and circumstances. Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964); Ryza v. Commissioner, T.C. Memo. 1977-64. The most important factor is whether Husband and Wife intended to, and did in fact, join together in Year 3 to operate the Franchise.

Husband contends that he intended to operate the Franchise as a partnership with Wife in Year 3. To establish the partnership, Husband contends that he continued to make contributions to the Franchise during that year. Noteworthy, contributions one party makes to a venture is only one factor to be considered in determining whether there was an intent to operate as a partnership. Such a factor, even if true, is not determinative. Wife contends that Husband and Wife agreed to treat the Franchise as Wife's separate property.

Based on the facts provided, no facts have been established which would indicate whether the Franchise was operated as a partnership. To establish if Husband and Wife operated the Franchise as a partnership, the following factors should be determined:

1. Who had control over the income and capital of the Franchise and the right to make withdrawals;

2. Who was entitled to the net profits;

3. Who was obligated to share losses; and

4. Whether Husband and Wife represented themselves to others as being in a partnership.

See Commissioner v. Culbertson, 337 U.S. 733, 742 (1949); Commissioner v. Tower, 327 U.S. 280 (1964); Luna, 42 T.C. at 1077-78. Because such facts have not been provided, it is not possible to determine whether a partnership existed in Year 3.

However, if a partnership existed, Treas. Reg. § 1.879-1(a)(4), which provides, "if both spouses are members of the same partnership, the distributive share of the income of each spouse shall be treated as the income of that spouse," would apply. See also Treas. Reg. § 1.1402(a)-8(b). Treas. Reg. § 1.879-1(a)(4) goes on to say, "A spouse's distributive share of the income of a partnership that is community income shall be determined as provided in section 704 and the regulations thereunder."

Accordingly, if a partnership existed, Husband apparently would be entitled to a share of the losses, depending on the application of the rules of section 704 and the underlying regulations.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

DEBORAH A. BUTLER

By: ______________________________
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