BEFORE THE STATE TAX APPEAL BOARD
OF THE STATE OF MONTANA

OTTO AND FRANCES BALTRUSCH, Appellant, -vs- DEPARTMENT OF REVENUE OF THE STATE OF MONTANA, Respondent.	)	Docket No. IT-2009-1 ORDER

Hearing in the above-entitled matter before the State Tax Appeal Board ("Board") was held on March 17 and 18, 2011. The Taxpayer, Frances Baltrusch, appeared through her counsel, James A. Patten and W. Scott Green, and Leonard Deppmeier, Certified Public Accountant, testified for Frances Baltrusch. The Montana Department of Revenue appeared through its counsel, Joel E. Silverman and Amanda L. Myers. Spencer Marks, Department auditor, testified about his audit and William Baltrusch testified about the property transfer. From the evidence received at the hearing and argument of counsel, the Board now enters the following:

ISSUE

The issue is whether the transfer of title of a farm to Otto Baltrusch was a non-taxable distribution of partnership property or a taxable sale.

The Montana Department of Revenue ("DOR") adjusted Otto and Frances Baltrusch's ("Appellants") 2002 Montana Individual Income Tax return based upon an audit of a transaction relating to a court-supervised sale of certain farm property.

The DOR argues the farm property at issue was owned by the partnership of Otto and his brother, and thus, when the title was transferred, it was a sale by the partnership, and Otto must recognize a taxable gain on sale of partnership property.

Otto (through his widow, Frances) argues that under partnership law, Otto did not engage in a taxable transaction, but received his half interest in the property as a non-taxable transfer from the partnership and the other half as a purchase from his brother.

EVIDENCE PRESENTED

1. Otto Baltrusch Jr. ("Otto") is deceased. (Stipulated Fact # 1.)
2. Otto and his brother, William Baltrusch ("William"), conducted various business enterprises in the form of a partnership under various names including Baltrusch Brothers, Baltrusch Construction Company, and Baltrusch Land & Cattle Co. (Stipulated Fact # 2.)
3. Otto and William acquired real property in Hill and Blaine Counties, Montana, and held title to those properties as "Otto Baltrusch, Jr. and William Baltrusch" doing business as "Baltrusch Construction Company" or as "Baltrusch Land and Cattle Co." or as "Baltrusch Brothers." (Stipulated Facts # 3.)
4. Otto and William, as a partnership, farmed real property (hereinafter "farm property") in Hill and Blaine Counties from approximately 1974 through October 2002. (Stipulated Facts # 4.)
5. There is no written partnership agreement between Otto and William for Baltrusch Construction Company, Baltrusch Brothers, or Baltrusch Land and Cattle. (Stipulated Facts # 5.) No evidence was presented of a formal transfer of title of any real property from Otto and William to the Baltrusch Land and Cattle Company or any partnership the brothers may have formed.
6. William and Otto had various disputes which have been adjudicated by Montana courts over many years. The Twelfth District Court issued a judgment in 2000, amended in 2001, ordering the partnership property, including the farm property in Hill and Blaine counties, be liquidated, the various draws, compensation, and

other transfers occurring between the various businesses and Otto and William capital accounts be equalized and the remaining funds be equally divided between them. *W. Baltrusch v. O. Baltrusch*, Twelfth Judicial District Court, Hill County, Cause No. DV 92-029. (Stipulated Fact # 6.)

7. The case was not, however, closed nor was the Order considered a final order in the case. (Order and Memorandum in Support of Amended Findings of Fact, Conclusions of Law, and Order (*sic*), App 65, line 11, Jan 3, 2005). Significant subsequent litigation occurred under the same cause number.
8. In 2002 (while litigation was on-going), the brothers entered into a Stipulation for Sale of Property filed with the Court in Cause No. DV 92-029. (Exhibit 24. Stipulated Fact # 7.)
9. The Stipulation for Sale of Property indicates that the parties co-owned various parcels of real property, including the farm parcel in question. Specifically, William and Otto Baltrusch agreed "The parties' farm and ranch real property in Baltrusch Land and Cattle Co." was to be listed for sale. "All other property co-owned by the parties individually shall also be jointly listed for sale." (Stip. Exh 24.)

SALE OF THE FARM PROPERTY

10. In accordance with their Stipulation For Sale of Property, Otto and William entered into a Standard Listing Contract dated April 18, 2002 with a listing price of $4,720,000. (Exhibit 1.)
11. The Standard Listing Contract identified the sellers, at line 4, as Otto and William Baltrusch. (Exhibit 1.)
12. The Standard Listing Contract identified the property to be sold, at line 15, as "Commonly known as Baltrusch Land & Cattle." (Exhibit 1.)
13. The Standard Listing Contract allowed, at lines 46 and 47, the "Owner and or

Owners may choose, at their option, to enter into a 1031 Tax Deferred Exchange upon the sale of this farm". (Exhibit 1.)

14. The Standard Listing Contract was signed, at lines 95 and 99, by Otto Baltrusch and William Baltrusch, individually, as sellers. (Exhibit 1.)
15. Included in the sale were State of Montana land leases which were held in the name of Otto and William, individually, as lessees. (Exhibit 25.)

BUY-SELL AGREEMENT AND SALE TO OTTO

16. Otto proposed, and William accepted, a purchase by Otto that provided for the equivalent of the full listing price of $4,720,000.
17. On August 25, 2002, Otto signed, as buyer, a Buy-Sell Agreement which was accepted by Otto and William as sellers. (Exhibit 2.)
18. The Buy-Sell Agreement, at lines 27 through 34, set a purchase price of $4,720,000, with $2,360,000 for the cash purchase of the 50% ownership to be paid to William, and less a credit of $2,360,000 credit to Otto for his 50% ownership.
19. William reserved, at line 136 through 138, the right to engage in a 1031 tax deferred exchange.
20. The purchase closed on October 9, 2002 through the Hill County Title Company. As per the Settlement Statement, Otto initially paid earnest money of $400,000, and the remaining amount $2,097,036.64 was paid at closing. After credit and adjustments of closing costs, the amount of $2,244,767.04 was paid first from Hill County Title Company to Baltrusch Land & Cattle and then from Baltrusch Land & Cattle Co. to William. (Stipulated Fact 10.)
21. A mineral deed, appurtenant to the sale of the farm property, shows the transferor as "WILLIAM H. BALTRUSCH and OTTO BALTRUSCH, JR., partners d/b/a Baltrusch Brothers, a partnership." (Stipulated Fact 12.)

22. The farm property deeds show the Grantors as "William H. Baltrusch and Otto Baltrusch, Jr., doing business as a partnership of Baltrusch Land & Cattle Baltrusch Construction Company, and Baltrusch Brothers." (Exh. Stipulated Fact 13.)
23. A Hill County Title check was issued to DNRC with the memo line stating "Water Rights transfer/Baltrusch L&C to O. Baltrusch Q17007-A lands located in Hill and Blaine." (Exh. Stipulated Fact 14.)
24. The Tax Information Sheet prepared by the title company shows the seller as "William H. Baltrusch," "Otto Baltrusch, Jr.," "dba Baltrusch Land & Cattle Ptr." and "dba Baltrusch Construction Ptr." (Exh. Stipulated Fact 15.)
25. Closing of Otto's purchase was originally scheduled for September 30, 2002. A dispute arose between Otto and William when William demanded that Otto pay $4,720,000 at closing and Otto insisting that he was only required to pay $2,360,000 plus additional amounts for the costs of closing and real estate commissions. Otto sent a demand to William's attorney, Dale Schwanke, that William specifically perform his obligations under the Buy-Sell Agreement and close the transaction. (Exhibit 29.)
26. Closing was held on October 9, 2002. At the closing:
    a. Otto paid $2,475,232.96 to Hill County Title Company, Exhibit 3, line 520, and,
    b. after deduction for closing costs (Exhibit 3, line 603) a check was issued by Hill County Title Company payable to Baltrusch Land & Cattle in the sum of $2,244,767.04, (Exhibit 4) and,
    c. finally, a check was written from Baltrusch Land and Cattle to William as "Seller" for $2,244,767.04 by Baltrusch Land & Cattle.
27. The Settlement Statement (Exhibit 3) identifies the sellers as William H. Baltrusch, and Otto Baltrusch, Jr., d/b/a Baltrusch Land & Cattle, Ptr., d/b/a

Baltrusch Construction Ptr., d/b/a Baltrusch Brothers, Ptr., and is signed with William and Otto as the sellers without any indication of a partnership. The disbursement check from Baltrusch Land & Cattle to William, (Exhibit 4), has the notation: "1/2 ownership int. Baltrusch Farms land and improvements."

28. The Closing Escrow Instructions (Exhibit 7) are signed by William and Otto as sellers; the proration and payment of real estate taxes (Exhibit 7) is signed by William and Otto as sellers. The Tax Information Sheet (Exhibit 9) is signed by William and Otto as sellers. On each of the document the two brothers signed as individual owners, doing business as partners. Even though the forms provided signature lines for partnership signatures, those lines were not signed.
29. The Realty Transfer Certificate filed for the subject property lists William H. Baltrusch and Otto Baltrusch Jr., dba Baltrusch Brothers as the Sellers of the subject property. (Stip. Exh 11.)
30. The Commitment for Title Insurance (and separate deeds) showing that the brothers held title to those properties as "Otto Baltrusch, Jr. and William Baltrusch" doing business as "Baltrusch Construction Company" or as "Baltrusch Land and Cattle Co." or as "Baltrusch Brothers." (Stipulated Exhibits 6 and 10, Commitment for Title Insurance, at BALT_DOR 000537, 000547-000548.)
31. In testimony, the farm operations were described as being financed through the partnership, and liability insurance payments, improvements, property tax and livestock payments were made by the partnership. (Deppmeier test. P 15, ll 17-24, p. 16, pp. 61-62.)
32. There was no evidence or testimony on how the farm was initially purchased titled, or financed.
33. The Substitute Form 1099-S listed the partnership as the Seller of the subject

property. (*See* Stip. Exh 12.)

34. Otto received no proceeds from the sale of the property.

TAX FILINGS AT ISSUE

35. No income from the sale was reported on Otto Baltrusch, Jr. and Frances Baltrusch's 2002 individual federal and state income tax returns as a result of the farm property purchase or sale, although William did report income on his individual return from the sale of the farm property. (Stipulated Fact 11.)
36. Otto and Frances Baltrusch's accountant, Leonard Deppmeier, a Havre CPA, prepared their individual income tax returns and Baltrusch Land & Cattle Co.'s partnership returns for both the state and federal governments in 2002. (Stipulated Fact 16.)
37. Testimony demonstrated that as between Otto and William, Otto was the manager of the farm and made all decisions with respect to the operation of the farm and management of the partnership. Otto was the "tax matters partner." (Exhibit 13., Deppmeier Testimony.)
38. Leonard Deppmeier prepared the partnership 2002 IRS Form 1065 as well as the Otto and Frances Baltrusch's individual 2002 IRS Form 1040 and the 2002 Montana individual income tax return Form 2. (Exhibits 17 and 27.)
39. The 1065 partnership return, Exhibit 13, explains the farm purchase as a non-taxable distribution of the real property to the partners followed by a purchase of William's interest by Otto.
40. The final signed settlement statement demonstrates that Otto paid half of the sales prices to Otto. (Exhibit 3.)

STATE TAX AUDIT

41. William's attorney, Dale Schwanke, corresponded as a whistle blower with both

the Internal Revenue Service and the Montana Department of Revenue, causing the examinations of Otto and Frances Baltrusch's 2002 tax returns and the partnership Form 1065 by both revenue authorities.

42. The Schwanke letter was not entered into evidence, and there is no indication when the letter was sent to the Department of Revenue. DOR auditor Spencer Marks' testimony indicates that the investigation by the DOR happened no earlier than 2006, when Mr. Marks began employment with the DOR.

43. The Internal Revenue Service conducted an examination of Otto's 2002 tax filings, both individual and partnership, and made no change to the report of the farm transaction as a result of its examination. (Exhibits 40 and 41, Testimony Deppmeier.)

44. The Internal Revenue Service examination required other changes to Otto and Frances Baltrusch's 2002 federal income tax return based on matters not involved in this hearing. (Exh 26, dated February 10, 2006.) Otto and Frances amended their Montana 2002 income tax return to reflect the changes required by the Internal Revenue Service. (Exhibit 27.)

45. At some point after close of the transaction, Dale Schwanke, William Baltrusch's attorney, provided a packet of documents to the Department claiming Mr. Deppmeier misreported the sale of the farm property for tax purposes. (Marks Testimony, p.157, ll.9-20.) Mr. Schwanke's information resulted in a desk audit by Marks, the Department's partnership tax auditor, of the 2002 Partnership and Otto and Frances's individual returns. (*Id.*; Marks Testimony, p. 152, ll. 10-14; *See also* Stipulated Exhibits 3, 4, 6, 7, 8, 9, 10, 11, 13, and 14.)

46. Marks testified that he waited to make a final audit determination until after the Supreme Court issued an order regarding William and Otto's legal dispute in June 2008. (Marks Testimony, p. 172, ll. 5-15; *See also* Stipulated Exhibit 16.)

Marks' audit was based on the evidence provided in Stipulated Exhibits 3, 4, 6, 7, 8, 9, 10, 11, 13, and 14. (Marks Testimony, p. 181, l. 1 through p. 190, l. 2. Stipulated Exhibits 1, 2, 5, 12, 19, 21, 22, 23, and 24 also bolstered his audit opinion. *Id.*)

47. Marks' audit determination resulted in an August 2008 statement of account adjusting the tax liability for Otto and Frances Baltrusch due to the determination that the farm property was sold by the partnership to Otto so that Otto realized a taxable gain.
48. The Statement of Account determined that an additional $192,409 in taxes, with $109,407 in interest and $33,752 in penalties was due and owing.
49. A substantial portion of the penalties and interest derive from the fact that the DOR waited at least three years to begin the audit and did not send the SOA until more than five years after the filing of the initial tax return. During most of that time the audit was complete and Mr. Marks was waiting for a decision by the Montana Supreme Court on an unrelated issue.
50. The testimony was clear that William, through his attorney, instituted the federal and state investigations into Otto's tax filings. No financial benefit accrues to William from the tax treatment of the transfer to Otto.
51. In testifying on behalf of the DOR, William insists that because he recognized a capital gain from the sale, so should his brother Otto.

From the foregoing Evidence Presented, the Board now enters the following

APPLICABLE LAW, FINDINGS OF FACT AND CONCLUSIONS OF LAW

General Partnership Taxation

1. Partnerships are pass-through entities not taxable in themselves. (26 U.S.C. 701.) Income and expenses received by a partnership are reported by the partners, whether or not received by the partners, according to the distributive shares in the partnership agreement. (26 U.S.C. 704(a).) Transferring property to the partnership by a partner is not a taxable event (26 U.S.C. 721) nor is distributing property from a partnership to a partner a taxable event. (26 U.S.C. 731(a)(1).)
2. Montana law requires that a partner's individual income tax be determined pursuant to 26 U.S.C. § 704 and the taxpayer is to submit a copy of the federal schedule of the partner's share of income pursuant to M.C.A. § 15-30-3311(1).
3. A partnership is required to file a federal form 1065 (reporting partnership gain and loss) describing the income and transactions.
4. Transactions between a partnership and a partner generally fall into one of two categories: (1) a sale or (2) a distribution. IRC §§ 707, 731-737. A sale can produce income taxable to the partners, a distribution of property generally is not a taxable event. IRC §§ 702, 731.
5. A distribution is "a transfer of money or other property from a partnership to a partner in the partner's capacity as a partner." Section 35-10-102(3), MCA.
6. A distribution can include a complete or partial liquidation of a partner's interest. See e.g. IRS publication 541 (partnerships). If the partnership distributed real property to a partner, the partner does not generally recognize gain until the sale or other disposition of the property. 26 U.S.C. 731(a)(1).
7. When assets are distributed to partners in the liquidation of a partnership, not in cash, but in kind, the partner receiving such assets realizes no gain or loss until he or she disposes of the property received in liquidation. *Cora-Texas Mfg. Co. v. United States*, 222 F Supp 527, affd 341 F2d 578 (1965, CA5 La).
8. A partner who engages in a transaction with a partnership other than in his

capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transactions. Treas. Reg. §1.707-1(a).

9. A partner is not acting in his capacity as a partner when, for example, trading for his own account (*Estate of Preisser v. Commissioner* (1988) 90 TC 767, affd (1989, CA10; *Shotts v. Commissioner* (1990) TC Memo 1990-641.), or providing services to the partnership generally identical to services provided to others for a fee (*Cagle v. Commissioner* (1974) 63 TC 86, affd (1976, CA5) 539 F2d 409; Rev Rul 81-301 (1981) 1981-2 CB 144.) Under regulations to be issued, factors such as whether a partnership interest is transitory, whether the interest is received for services rendered or whether the transfer makes income allocations unfeasible, may to be used to determine when a partner is acting outside of his capacity as a partner. None of these elements are present in this case. AMJUR FEDTAXN 2277**,** S Rept No. 98-169, Vol. 1 p. 226.

Findings of Fact, Conclusions of Law and Discussion

This Board has jurisdiction over this dispute. This Board adopts as a Conclusion of Law any Finding of Fact that may also constitute a Conclusion of Law.

Analysis of this transaction, and whether the DOR properly adjusted the tax liability, must start with the statutory framework laid out above which assumes that transfers of property between a partner and a partnership are not taxable events. We thus analyze the documents in light of that statutory scheme.

To create a taxable event, the DOR relies heavily on the format of certain documents created at the time of the transfer. We find their analysis unpersuasive for two reasons. First, we find the documents, taken as a whole, are ambiguous as to the ownership and transfer of the ownership of the farm. Second, the Department cannot change the operation of the tax code to create a taxable event. The fact that William wanted to create a taxable event for his brother where there was none under

the statutes is not controlling here.

There are many ambiguities in the documentation relating to the ownership and transfer of the farm. For example, the 2002 Stipulation for Sale, the listing agreement signed putting the farm on the market for sale, and the buy-sell agreement of August 25, 2002 were all signed by the brothers individually. *See ,e.g.,* EP 10,11, 17. The Stipulation of Sale also allowed for tax advantaged treatment of the sale by allowing either party to utilize a 1031 exchange, which would not be possible without individual ownership and with individual ownership, no partnership sale could occur to trigger tax liability. *See* Exh. 24_. We find the documents evidencing this transaction were not consistently signed as if the property were partnership property rather than simply co-owned by the brothers. As a matter of fact, we find that there is enough ambiguity in the documentation of the transaction, *i.e.*, the deeds, the closing statements and the court directive, to prevent the transaction being treated as a sale from the partnership.

Indeed, we find the ownership of the farm itself ambiguous. There is no clear evidence that the property was ever legally transferred to the partnership and the parties have stipulated that there was never a formal partnership agreement. Thus, the evidence presented to the Board is unclear as to the actual legal status of the property prior to the transfer[1].

It is clear, however, that Otto owned half of the real property and was running a farm business. Section 35-10-203, MCA, directs what type of property is partnership property and not property of the partners individually. Subsection (2) requires that

[1] During this litigation, the DOR filed a motion for summary judgment arguing that the 12th judicial district court order in similar litigation controlled in this matter. This Board upheld the summary judgment which was subsequently overturned by the district court, and remanded to the Board. 12th Jud. Dist Ct, DV-09-079, 4/29/2010. The parties subsequently went to hearing before the Board and presented evidence which is addressed in this order. The district court initially directed that "Otto should be responsible for the payment of any income tax that have been, or might be incurred by William in excess of what he would have paid had the seller been the partnership." App 38, P 4. William did not pay any income tax in excess of what he would have paid had the seller been the partnership and the Board's opinion today also does not affect William's tax liability.

the property be acquired in the name of (a) the partnership; or (b) one or more of the partners with an indication of the person's capacity as a partner. In this case, the evidence presented doesn't meet the test or is at least ambiguous about whether the property is actually partnership property. No evidence was presented to show how property was purchased, whether from partnership assets, or how it was titled, and it was admitted at the hearing that no formal agreement existed between the partners specifying asset ownership. While it is true that the buy-sell is ambiguous as to the legal ownership of the property by failing to note legal ownership structure, and the brothers signed in their individual capacities (Exh. 2), property is presumed separate from partnership property if it is purchased in the name of one or more of the partners without an indication that title is transferred to the partnership and if it was not purchased with partnership assets, even if it is used for partnership purposes. Section 35-10-203(5), MCA. Thus, Montana code does not permit an asset to be considered a partnership asset simply because of a pattern of usage or common understanding. Based on the evidence presented, such appears to be a possibility in this case.

Further, the Montana Supreme Court held in *In re Estate of Bolinger*, cite, that the question of whether property belongs to a partnership depends on the intent of the partners. *Bolinger*, p.81. Such intent may be inferred from a variety of sources, such as an agreement between the partners or by the partners' conduct. *Id.* The Court has held, however, that merely including the property on partnership tax returns is insufficient for a court to make a determination that the property is partnership property. *McCormick v. Brevin*, 2004 MT 179, ¶ 69. In this instance, there was no testimony or evidence regarding the initial purchase of the farm property and whether it may have been purchased with partnership funds.

Many of the documents at the transfer were signed by the brothers as individuals, indicating they operated as co-owners of the property. There is sufficient

informality in their dealings that the question remains unanswerable on the evidence before us, but we find that to construe the transaction as a sale by the partnership to Otto, the question of title would have to be resolved in favor of the partnership. For resolution of the tax matter at hand, we need not resolve that question.

In fact, it was not until the closing approached that William, realizing that he would be taxed as seller and Otto, as buyer, would not, insisted the documents reflect a sale to Otto of the half interest Otto already owned. Otto did not comply with William's demand that he tender the entire price of the farm at closing and only submitted half the amount, to purchase the half interest he did not already own (as was agreed to in the contract.) Furthermore, Otto and William signed the deeds in their individual capacity, and in their partnership capacity. *See* Exh. 6.

All of the documents relating to the sale indicate a transaction whereby Otto paid 50% of the value of the property to William. Exh. 1, 2, 3, 4, 5, 6, 7, 8, and 9. We find that the economic substance of the transaction was that Otto purchased William's one-half interest in the farm property.

Distribution in Liquidation

If, in fact, the partnership owned the farm property, we find the property was transferred pursuant to a distribution in liquidation. In this analysis, we find the property transfer may properly be treated as a step transaction[2], with partnership proceeds distributed to Otto and William, and Otto purchasing William's interest in the farm.

It is well settled in cases and statute that "[o]rdinarily, upon liquidation of a

[2] The process of collapsing the various steps engaged in by taxpayers structuring transactions in search of tax advantages, in order to analyze the real economic substance of the transaction, is often referred to as a step transaction analysis. The test is whether the transaction has a real economic purpose aside from the tax advantages it confers on the parties.

partnership, not in cash, but in kind, partner receiving such assets realizes no gain or loss thereon until he disposes of property received in liquidation." *Cora-Texas Mfg. Co v. U.S.* (1963, ED La) 222 F. Supp 527, *aff'd* (1965 CA5 La) 341 F2d 578, Section 26 U.S.C.S. 731. Therefore, whether the property is owned by the partnership, or by the brothers as co-owners using the property in a working partnership, the end result is the same. If owned by the partnership, then transfer of the farm is a § 731 distribution of Otto's half interest to Otto; if co-owned, then Otto bought out William's interest and simply retains his own interest.

What should have been a simple, tax deferred transaction was thus complicated by directives outside the Taxpayer's control. Bill attempted to impose taxation on Otto by characterizing the transaction as a sale of Otto's own half-interest to himself, even though there is no doubt in any of these disputes that Otto legitimately owned a half interest in the farm property. The ambiguity in the ending paperwork, which was entirely out of the taxpayer's control, creates an unclear situation that DOR would take advantage of to immediately tax Otto, even though federal and state tax policy clearly allows for the tax deferred transaction in a partnership situation.

We find the transaction may be considered a distribution in liquidation and taxation of the transaction is improper in this instance.

Analyzing the Documentation

This Board has reviewed a substantial amount of partnership tax case law, and has found no cases precisely detailing a similar set of facts and circumstances[3] which is

[3] In older Montana Supreme Court cases, the Montana Supreme Court noted with favor that other states do not require sale of partnership assets upon a judicial determination that partnership assets must be divided. *See Doting v. Trunk*, 259 Mont. 343 351(1993) discussing Michigan and Oregon cases and other UPA determinations. *But see McCormick v. Breving*, 2004 Mont. 179, requiring sale of property when using statutory dissolution methodologies. In this instance, however, the disposition of the subject property occurred due to the stipulation between the parties and not as a direct court ordered sale. Thus, we first note there are no legal requirements that transfer of the farm property,

due, at least in part, to the fact that taxpayers generally try to avoid taxability rather than create it. In this instance, it is the Taxpayer who argues that the economic substance of the transaction and the ambiguity of the associated paperwork require treatment of the transfer as a distribution of a partnership asset. In contrast, the DOR wants us to focus on the form of the transaction, claiming the Taxpayer failed to specifically and properly title the property and design the transaction to allow for tax advantaged treatment. Presumably, for tax liability to be avoided by Otto, the partnership would have transferred title to an aliquot share of the property to each of the brothers and William would then have sold his half to Otto, transferring title a second time. Instead, at William's insistence, Otto paid for William's half with a check to the partnership which then paid William, thus collapsing two title transfers down to one. William sold his share to Otto and chose to cycle the cash payment through the partnership. The end result is the same, as there was no economic rationale for either partners or partnership to characterize this transfer as a sale.

This situation is generally contrary to a typical governmental challenge of tax treatment: it is generally the government that alleges the courts must look to the economic substance of a transaction, and to ignore the ambiguous paperwork which would allow for tax advantaged treatment of a multi-step transaction. It is a fundamental principle of partnership tax law that a transaction will be examined on its actual substance and not its form. Income Tax Regulation § 1. 701-2(A)(2). When reviewing the substance of the transaction, we find that Otto does not accrue a tax liability for purchasing William's interest in the farm. We note that the Internal Revenue Service examined the transaction in the course of auditing Otto and Frances'

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initially contemplated as a sale on the open market to a third party must be treated as a sale when transferred to one of the partners. Further, we find the property was not sold under a Court order of dissolution requiring the cash liquidation of the partnership's property, so a sale of the entire farm property was not legally required.

return and upheld their characterization of the transaction as an untaxed transfer. To treat the substance of the transaction as a sale at the partnership level requires the Board to ignore the economic reality of the transaction, and we refuse to do so.

Action as a Partner

The Department argues that Otto was not acting in his capacity as a partner in taking title to the property and that the disguised sale treatment required by 26 USCA 707(a)(2)(B) should apply. We are not persuaded by the DOR's argument for two reasons. First, the code section carving out transfers not done as a partner, §707(a)(2)(B) of the IRC, clearly requires a two-part transaction: first a transfer of money or property to the partnership and then, generally at a later time, a related transfer of money or property back to the partner. These transfers usually occur in a situation that lacks economic substance for the partnership but results in a private benefit to the partner. The resulting transfer is then recharacterized by the IRS as a disguised sale between the partner and the partnership. Here, however, Otto only paid the partnership the agreed full market value price for his brother's half of the property and he does not dispute that was a purchase.

Second, we find no evidence that Otto was acting outside his capacity as a partner when he received his half interest in the farm as a distribution. We find there are no special circumstances indicating he was acting as other than a partner. The partners were in the process of dissolving the partnership and distributing the property they jointly owned, which is not outside the general structure of a partnership.

Treating a terminal distribution of property as a sale would erase the distinction between a partnership and an S corporation (a form often used in family businesses, which, under §1363 of the IRC, must recognize gain on the distribution of appreciated property to its shareholders, thus treating the transfer as a sale.)

Contributing property to a partnership and receiving property from a partnership, however, are not unusual acts in the life of a partnership. Sections 721 and 731 of the IRC specifically make those transfers non-taxable events and we see nothing in this transaction to suggest otherwise[4]. Otto was not conducting a second private business operation outside the partnership which required his acts to be distinguished from his actions as a partner in the dissolution of his partnership. Concluding that he was not acting as a partner just because the partnership was being dissolved would make §731 meaningless.

The DOR further argues that, even assuming that Otto was acting in his partnership capacity, a partnership may only distribute property with the consent of its partners. *Schrammeck v. Federal Sav. & Loan Ins. Corp.*, 258 Mont. 391, 397-98, 853 P.2d 702, 710-12 (1993); *See also* §§ 35-10-301(2), -401(6), and -405, MCA. By statute, an act outside the ordinary course of business of a partnership and an amendment to the partnership agreement may be undertaken only with the consent of all the partners. Section 35-10-401(10), MCA. The DOR argues the partnership needed William's consent in order to distribute the farm property. William testified he never consented to the distribution of the farm property and further testified that he would have never sold the property to Otto unless it was a sale by the Partnership.

The facts show, however, that William signed the stipulated agreement for sale of the farm property, as well as signing the buy-sell agreement and ultimately selling his portion of the farm property to his brother Otto for full fair market value. This is a demonstrable consent to the transaction. He was advised by counsel every step of the way. He cannot, now, years after he sold the property to his brother, allege he did not consent to the sale under the agreed terms.

[4] In fact, §731(a)(2) discusses liquidation distributions specifically permitting loss recognition in certain circumstances not here relevant.

Here, both the DOR and William attempt to manipulate the intent of the tax laws and the agreement between the brothers to create a tax disadvantaged situation for Otto. The DOR ignores the fact that the disposition of partnership property stems from contentious litigation by the parties to dissolve the partnership. Had this been resolved by court order, there was no requirement for William to consent to the distribution. Instead, the stipulated sale agreement controls, and there is no room for doubt that William consented[5] to sign it.

In conclusion, we find that the property transfer may properly be treated as a step transaction pursuant to a distribution in liquidation, with partnership property distributed to Otto and William, and Otto purchased William's interest in the farm. The Board concludes that the tax laws provide for such treatment as a matter of course and there is nothing in this transaction that requires us to do otherwise.

In the alternative, there is sufficient evidence to demonstrate that the real property may not be partnership property, but rather property jointly owned by Otto and William. In that case, Otto consistently owned half of the property from the inception. Either interpretation is supported by the language of the stipulation for sale of certain property, the fact that Otto paid half of the uncontested fair market value, and that the IRS reviewed Otto's tax liability and did not change it supports this result.

LEGAL FRAMEWORK OF THE FARM TRANSACTION

[5] We note that there is no requirement for a settlement or liquidation to take into account the tax consequences of a division of assets. In earlier litigation, when determining how to equally divide partnership assets between two partners, the District Court did not account for the tax implications related to loans taken by one partner from the partnership, which that partner contended was error because the tax obligations related to the loans, as opposed to wage income, and would result in that partner receiving less money. The Supreme Court found no error in the District Court's calculations. If the partner had taken the money in wages rather than in loans, the taxes would have been paid immediately and there would be no controversy. The court declined to hold one partner responsible for tax implications based on the monetary decisions of the other. *Baltrusch v. Baltrusch*, 2003 MT 357, 319 M 23, 83 P3d 256 (2003).

Acceptance of Partnership Filing

Montana law requires that a partner's individual income tax be determined pursuant to 26 U.S.C. § 704 and the taxpayer is to submit a copy of the federal schedule of the partner's share of income pursuant to M.C.A. § 15-30-3311(1). The federal schedule reporting partner income is Form 1065. Therefore, Form 1065 dictates the tax treatment of the transaction. We find the reporting of the transaction on Partnership Form 1065 is consistent with the Listing Agreement, the Buy-Sell Agreement, and all of the closing documents including the deeds, as a purchase by Otto of William's interest in the property.

Otto's reporting of the transaction was not disputed by the Internal Revenue Service after its audit. *See* Exh 26 (Confidential.) There is no evidence that Otto and Frances Baltrusch's Amended 2002 Montana Individual Income Tax return was contrary to the Form 1065. In this instance, there is also no evidence that the DOR reviewed or adjusted the partnership filings. Thus, without a change to Form 1065, we see no reason in this case to allow the DOR to subsequently adjust Otto's liability, which is tied by state and federal law to the partnership forms filed.

Montana statutes are to be strictly construed in favor of the taxpayer. *State ex rel. Whitelock v. State Board of Equalization* (1935), 100 Mont. 72, 84, 45 P.2d 684, 687; *Haman v. State* (1993), 262 Mont. 458, 460, 865 P.2d 274, 275. Construing section 15-13- 3311, MCA strictly in favor of the taxpayer requires the taxpayer's partnership income be determined by IRS Form 1065.

DOR Penalties and Interest

The evidence indicates that William's attorney, Mr. Schwanke, reported the alleged problematic transaction to the DOR and IRS, though the timeframe for the report is unclear. Marks testified that while he had already calculated an additional

tax owed by Otto, he did not make a final audit determination until after a determination by the Montana Supreme Court on a separate legal dispute. The issues on appeal, however, had no relevance to the transfer of the farm here at issue. *See* Stip. Exh 16; *Baltrusch v. Baltrusch*, 2008 MT 245. Thus, Marks' determination was made several years after the letter from Schwanke, and more than five years from the date that an adjustment would have been due and owing for the Taxpayer. If the Taxpayer owed tax for the initial transaction, the tax owed would have totaled $192,409. Because the DOR subsequently sent a statement of account more than five years later, while waiting for an irrelevant decision from the Montana Supreme Court, the Taxpayer is now deemed to owe an additional $136,988.88 in penalties and interest to July 2008.

While there is no doubt that DOR has the authority to review and adjust tax returns, the case presents problematic facts for DOR in implementing penalties and interest.

We find the DOR's five year delay in issuing the statement of account against Otto was unnecessary in this case, and substantially increased the penalty and interest which accrued. We note the evidence and testimony presented does not support the implementation of penalties and interest in this matter, and should the reviewing court overturn this decision, we urge the court to review the application of penalties and interest in the matter.

ORDER

There is no factual or legal basis to support the Department of Revenue's additional assessment which should be reversed.

DATED this 22nd day of August, 2011.

MONTANA STATE TAX APPEAL BOARD

By:_/s/_____
KAREN E. POWELL

By:_/s/_____
SAMANTHA SANCHEZ

By:_/s/_____
DOUGLAS A. KAERCHER

CERTIFICATE OF SERVICE

THE UNDERSIGNED HEREBY CERTIFIES THAT ON THIS 22nd DAY OF AUGUST, 2011, A TRUE AND CORRECT COPY OF THE FOREGOING HAS BEEN SERVED ON THE PARTIES HERETO BY THE METHOD INDICATED BELOW AND ADDRESSED AS FOLLOWS:

James A. Patten
PATTEN, PETERMAN, BEKKEDAHL
& GREEN PLLC
28187 Second Avenue North, Suite 300

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/s/_____
Donna J. Eubank, paralegal assistant