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2020 – OTA – 182P
Precedential

**OFFICE OF TAX APPEALS**
**STATE OF CALIFORNIA**

| In the Matter of the Appeal of: | ) OTA Case No. 18063330 |
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| **M. DAVIS AND** | ) |
| **J. HUNTER-DAVIS** | ) |
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# OPINION

Representing the Parties:

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| For Appellants: | J. Hunter-Davis<br>Tim A. Tarter, Woolston & Tarter, P.C. |
| For Respondent: | Nathan H. Hall, Tax Counsel III<br>Peter Kwok, Tax Counsel IV |

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, M. Davis and J. Hunter-Davis (appellants) appeal an action by respondent Franchise Tax Board (FTB) in proposing to assess additional tax of $565,250, plus interest, for the 2012 tax year.

Administrative Law Judges Josh Lambert, John O. Johnson, and Daniel K. Cho held an oral hearing for this matter in Cerritos, California, on December 17, 2019. At the conclusion of the hearing, the record was closed, and this matter was submitted for decision.

## ISSUE

Whether the reported distributive share of capital gains totaling $9,461,508 from Bay Shores Investment, LLC (Bay Shores) may be reduced by $4,250,000, which is J. Hunter-Davis' (appellant-wife's) claimed basis in Bay Shores.

## FACTUAL FINDINGS

1. In 2012, appellant-wife owned a 2.24 percent interest in Bay Shores, which is classified as a partnership for income tax purposes. Bay Shores owned a 19.63 percent membership interest in Healthcare Partners Holdings, LLC (Healthcare).

2. In May 2012, Healthcare was acquired by DaVita Healthcare Partners (DaVita). Under the merger agreement, membership interests in Healthcare converted into the right of the interest holders to receive monetary payment and DaVita stock. DaVita was to make future payments from an escrow account to Healthcare's former interest holders, such as Bay Shores, in installments between 2012 and 2017. Bay Shores set up an account receivable for future payments. Subsequently, DaVita claimed that it overpaid in the merger and brought a lawsuit against Healthcare.
3. Bay Shores elected out of the installment method of reporting at the partnership level and reported its total allocable share of the merger consideration as long-term capital gain for the 2012 tax year. Bay Shores' 2012 tax return reported total assets of $143,477,961 at the end of the tax year, which included $800,013 in cash. The 2012 Schedules K-1 (K-1s) issued by Bay Shores to its partners reflected each partner's distributive share of this amount. In addition, the K-1s reported the amount of any funds distributed to the partners.
4. Bay Shores issued appellant-wife a 2012 K-1, which reported a distributive share totaling $10,326,435. This amount included net total capital gains of $9,461,508 (net long-term capital gain of $9,460,005 and short-term capital gain of $1,503), ordinary income of $836,904, interest income of $27,956, and dividends of $67.
5. The K-1 also reported that appellant-wife received a distribution totaling $10,534,242 ($9,202,271 in "cash and marketable securities" and $1,331,971 in "property other than money").[1] The "final Schedule K-1" box on the K-1 was not checked. The K-1 reported appellant-wife's ending capital account in the amount of $3,459,464.
6. On October 15, 2013, appellants jointly filed a California income tax return, reporting net capital gains of $9,461,508 and a capital loss of $4,250,000, which is appellant-wife's alleged basis in Bay Shores. As a result, appellants' reported net capital gain from Bay

[1] According to the merger agreement, Healthcare members could elect to receive all cash or all DaVita common stock, or a combination thereof. During the hearing, appellants stated that it is "stipulated . . . that all the partners received some shares of DaVita," and appellant-wife testified that she "received some shares of DaVita." The "DaVita Transaction proceeds schedule" provided by appellants indicates that appellant-wife received DaVita shares valued at $1,331,971, which is the same amount indicated on the 2012 K-1 under "Distributions of property other than money." Therefore, it appears that DaVita common stock was received in the distribution and the fair market value of the stock is reported on the K-1 as "Distributions of property other than money."

Shores was reduced to $5,210,574.[2] The distribution totaling $10,534,242 was not reported by appellants on their California return and, as a result, was not subject to tax.

7. Bay Shores continued to file tax returns and issue K-1s until 2018. For 2013, Bay Shores issued a K-1 to appellant-wife indicating a distribution of $459,528. The K-1 reflected that appellant-wife's capital account was reduced by the distribution, and that her ending capital account balance was $2,999,242. Appellant-wife did not report the distribution of $459,528 on her 2013 income tax return and, as a result, the amount was not subject to tax.[3]

8. Bay Shores' 2014 tax return reported that it had total assets of $104,346,098 at the end of the tax year, which included $26,663 in cash.

9. In 2018, Healthcare and DaVita agreed to a settlement, allowing the remaining funds in the escrow account to be distributed to the former members of Healthcare, including Bay Shores.

10. For 2018, Bay Shores issued a K-1 to appellant-wife indicating a distribution of $636,896. On the 2018 K-1, the "final Schedule K-1" box was checked. The K-1 decreased appellant-wife's capital account by the amount of the distribution plus the remaining amount in her capital account, $2,351,569, resulting in an ending capital account balance of zero.

11. For the 2012 tax year, FTB issued a Notice of Proposed Assessment (NPA) to appellants on June 1, 2017, which disallowed the reported loss of $4,250,000, increased their taxable income by the same amount, and proposed an assessment of additional tax of $565,250, plus interest.

12. Appellants timely protested the NPA. On May 9, 2018, FTB issued a Notice of Action (NOA), affirming the NPA. This timely appeal followed.

13. On appeal, appellants argue that appellant-wife's basis in Bay Shores should be $4,804,429 instead of $4,250,000, and they provide a 2012 basis calculation in support. The basis calculation indicates a beginning basis of $3,455,249, an increase for the

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[2] Appellants reported other adjustments, including a capital carryover loss of $934 and Schedule CA adjustments of $64,163.

[3] Appellant-wife filed a 2013 California income tax return using a filing status of married filing separately.

distributive share totaling $10,326,435, other adjustments with a net total of $1,556,987, a decrease for the distribution of -$10,534,242, and an ending basis of $4,804,429.

14. FTB also provides a 2012 basis calculation that indicates a beginning balance of $3,453,718, an increase for the distributive share totaling $10,326,435, other adjustments with a net total of -$105,234, a decrease for the distribution of -$10,534,242, and an ending basis of $3,140,677.

## DISCUSSION

FTB's determination is presumed correct, and a taxpayer has the burden of proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Appeal of Seltzer* (80-SBE-154) 1980 WL 5068.)

### 1. Partnership Distributive Shares and Distributions

#### Partnership Distributive Shares

California conforms to Internal Revenue Code (IRC) section 702, pursuant to R&TC section 17851. Under IRC section 702(a), each partner must take into account his or her distributive share of the partnership's income including, but not limited to, gains and losses from sales or exchanges of capital assets and other business property. A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. (IRC, § 704(d)(1).)

#### Partnership Distributions

In the case of a distribution by a partnership to a partner: (1) gain is recognized only to the extent that money distributed exceeds the partner's basis immediately before the distribution; and (2) losses are only recognized to the extent of the excess of the partner's basis over the amount of the distribution, when the distribution is in liquidation of a partner's interest in a partnership, and where no property other than money, unrealized receivables, and inventory is distributed. (IRC, § 731(a)(1) & (2).) For purposes of IRC section 731(a)(1) and section 737,

the term "money" includes marketable securities, and such securities shall be taken into account at their fair market value as of the date of the distribution. (IRC, § 731(c)(1).) Gain or loss recognized under IRC section 731(a) on a distribution is considered gain or loss from the sale or exchange of the partnership interest of the distributee partner, that is, capital gain or loss.[4] (Treas. Reg. § 1.731-1(a)(3).)

Appellants Improperly Attempt to Treat a Distributive Share as a Distribution

Appellant-wife's 2012 K-1 reported a distributive share of total capital gains of $9,461,508. On their 2012 tax return, appellants reduced the $9,461,508 gain by appellant-wife's alleged basis of $4,250,000. During the hearing, appellants asserted that appellant-wife "reported $9,461,508 as long-term capital gain -- as gross, long-term capital gain. She also claimed a basis reduction to that number on her original [filed] return of $4,250,000." Therefore, while appellants reported a loss of $4,250,000, appellants provide argument and legal authority relating to the treatment of a distribution of gain and contend that the gain is recognized only to the extent that the distribution exceeds appellant-wife's basis, pursuant to IRC section 731(a)(1). However, the gain at issue that appellants attempt to reduce is not a distribution, but a distributive share. Appellant-wife received a separate amount as a distribution of $10,534,242, which was reported on the K-1 on a different line than the distributive share at issue of $9,461,508. The distributive share of capital gain of $9,461,508 is appellant-wife's allocation of Bay Shores' capital gain, whereas the distribution of $10,534,242 is a distribution from Bay Shores to appellant-wife of cash and DaVita common stock. As a result, the tax law applicable to the recognition of the distribution of gain under IRC section 731(a)(1), to which appellants cite, does not apply to the amount at issue.

Each partner must pay tax on his or her distributive share of the partnership's income regardless of whether the amount is distributed. (*U.S. v. Basye* (1973) 410 U.S. 1080, 1088; see also Treas. Reg. § 1.702-1(a).) The $9,461,508 at issue was a distributive share of gain, not a distribution; therefore, the entire amount is subject to tax, pursuant to IRC section 702(a). Accordingly, appellants cannot reduce appellant-wife's distributive share of gain by the amount of her alleged basis.

[4] However, the liquidation of a partnership interest by the partnership does not constitute a "sale or exchange" for purposes of causing a technical termination, pursuant to IRC section 708(b)(1)(B). (Treas. Reg. § 1.708-1(b)(2).)

## 2. Adjusted Basis of a Partner's Interest in a Partnership

### Adjusted Basis

IRC section 705 provides that the adjusted basis of a partner's interest in a partnership is his or her original basis, as determined under IRC section 722, increased by: (1) the amount of money and the partner's basis in property subsequently contributed to the partnership; and (2) the partner's distributable share of the income of the partnership. Additionally, the partner's adjusted basis is decreased (but not below zero) by: (1) the amount of money and the partnership's adjusted basis in property distributed to the partner in a nonliquidating distribution to the partner and; (2) his or her distributable share of partnership losses and expenditures. (IRC, §§ 705(a), 722, 732(a).)

### Appellants' Alleged Basis Already Includes an Adjustment for Both the Distributive Share and the Distribution

We note that appellants did not report the separate distribution of $10,534,242 on their 2012 tax return. However, according to appellants' basis calculation, appellant-wife had enough basis such that the distribution would not be subject to tax. Specifically, appellants' calculation indicates a basis before the distribution of $15,338,671 (i.e., $3,455,249 (beginning basis) + $10,326,435 (total distributive share) + $1,556,987 (other adjustments)). Therefore, appellants properly increased appellant-wife's basis by the distributive share, pursuant to IRC section 705. Given this increase to their basis for the distributive share, appellant-wife had sufficient basis such that no gain would be recognized on the current distribution of $10,534,242, pursuant to IRC section 731(a)(1). After reducing basis by the distribution, appellant-wife's ending basis is $4,804,429 (i.e., $15,338,671 - $10,534,242).[5] While appellants argue that appellant-wife's basis before the distribution was $4,804,429, their basis calculation indicates that the $4,804,429 amount was calculated only after reducing appellant-wife's basis by the distribution of

[5] FTB's basis calculation also shows that appellant-wife had sufficient basis such that the distribution would not be subject to tax.

$10,534,242. Therefore, appellants' alleged basis of $4,804,429 already includes an adjustment for the distribution.[6]

3. Appellants' Alternative Arguments Claiming Liquidation and Termination

At the hearing, appellants asserted that their "primary position" is that the amount at issue is a gain, and that they are "simply not addressing liquidation" and "not claiming a loss." However, appellants later stated that they are providing an "alternative argument" that "by the end of 2012 the appellant's interest was deemed liquidated" and that they should be able to "claim a basis loss." Appellants argue that their alleged basis of $4,804,429 should be recognized as a loss because appellant-wife received a distribution in liquidation of her interest in Bay Shores, pursuant to IRC section 731(a). Appellants also argue that Bay Shores terminated in 2012 and contend that Bay Shores ceased its business activity in 2012. Appellants contend that the distributions received by appellant-wife and the other partners amounted to a sale or exchange of 50 percent or more of the total interest in Bay Shores' capital and profits in 2012, causing a technical termination. Appellant-wife testified that after the merger in 2012, the only activity of Bay Shores was sending letters explaining that it was purchased by DaVita and that it no longer existed as a medical group. Appellants assert that, while Bay Shores was terminated in 2012, it continued to exist only in anticipation of receiving the remaining escrow amounts at the conclusion of the litigation between Healthcare and DaVita.

We determined that appellants improperly reduced appellant-wife's distributive share by her alleged basis of $4,250,000. Accordingly, we determined that FTB properly increased their taxable income by $4,250,000 on the NOA and that the proposed assessment of additional tax is correct. Appellants now argue that they are entitled to a loss with regard to the distribution, which they contend is a liquidating distribution. This would result in a capital loss of $4,250,000 allowed to the extent of their capital gains for 2012, which includes the capital gains from the

[6] We note that appellants improperly reduced appellant-wife's basis below zero in prior years, as follows: (1) 1997: -$79,354; (2) 1998: -$93,919; (3) 1999: -$66,568; (4) 2000: -$13,783; (5) 2005: -$347,088; and (6) 2006: -$28,156. In 2005, for example, appellants calculated a basis of -$347,088 after reducing appellant-wife's adjusted basis of $901,356 by a distribution of $1,248,444. However, a distribution cannot reduce a partner's basis below zero, pursuant to IRC section 705(a)(2). Instead, appellant-wife's basis should have been reduced to zero, and she should have recognized a gain on the excess of $347,088. These incorrect basis calculations indicate that their 2012 alleged basis may also be incorrect. However, it is unclear whether these errors affected the current year basis because, for example, there is no evidence in the record indicating whether appellants reported a gain for the distribution in 2005. As such, we will not address the matter further.

distributive share.[7] Additionally, appellants now claim they are entitled to a loss of $4,804,429, based on a revised basis calculation. Specifically, appellants contend they are allowed a loss of $4,804,429 for the difference between their alleged basis before the distribution of $15,338,671 and after the distribution of $10,534,242. However, we determined the proposed assessment of tax was correct; if we also determine a loss is allowed, we cannot reduce the proposed assessment by more than the amount indicated on the NOA. Therefore, while we will examine whether a loss should be allowed, we can only reduce appellants' taxable income by up to $4,250,000, not $4,804,429.

4. Termination of a Partnership

Termination Generally

An existing partnership shall be considered as continuing if it is not terminated. (IRC, § 708(a).) For tax years prior to December 31, 2017, a partnership shall be considered as terminated pursuant to IRC section 708(b)(1), only if: (1) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership;[8] or (2) if within any 12-month period, there was a sale or exchange of 50 percent or more of the total interest in partnership capital and profits within a period of 12 consecutive months (i.e., technical termination).[9] (IRC, § 708(b)(1)(A) & (B); Treas. Reg. § 1.708-1(a)(b)(2).) When the partners agree to dissolve the partnership and carry on business through a winding up period ending when all remaining assets, consisting only of cash, are distributed to

[7] Losses from sales or exchanges of capital assets are allowed only to the extent prescribed by IRC sections 1211 and 1212. (IRC, § 165(f).) As relevant here, those sections generally provide that capital losses shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) the lower of: (1) $3,000 ($1,500 in the case of a married individual filing a separate return); or (2) the excess of such losses over such gains. (IRC, § 1211(b).) Capital losses exceeding this limitation may be carried forward to subsequent tax years. (IRC, § 1212(b).)

[8] A partnership may also be terminated by the discontinuance of the partnership form, which occurs when: (1) the interests of all but one partner are liquidated or are purchased by that partner, and thereafter the business is carried on as a sole proprietorship; (2) when the partnership is incorporated; or (3) when the partnership elects to be classified as an association taxable as a corporation. (Treas. Reg. § 301.7701-3.)

[9] IRC section 708(b)(1)(B), dealing with "technical terminations," was repealed, effective for taxable years beginning after December 31, 2017. (2017 Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13504(a) (Dec. 22, 2017).)

the partners, the partnership does not terminate until that date.[10] (Treas. Reg. § 1.708-1(b)(1) & (b)(4).)

Technical Termination of a Partnership

For tax years prior to December 31, 2017, a partnership is terminated if within any 12-month period, there was a sale or exchange of 50 percent or more of the total interest in partnership capital and profits within a period of 12 consecutive months. (Treas. Reg. § 1.708-1(a)(b)(2).) Such sale or exchange includes a sale or exchange to another member of the partnership. (*Ibid.*) However, a disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest, is not a sale or exchange. (*Ibid.*) In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. (IRC, § 741.) Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in IRC section 751 (relating to unrealized receivables and inventory items).[11] (*Ibid.*)

Whether there is a sale or exchange of a partnership interest is a question of fact. (*Foxman v. Commissioner* (3d Cir. 1965) 352 F.2d 466, 469 (*Foxman*).) In determining whether a transaction constitutes a sale or exchange, we may look through the form of the transaction to its substance. (*Ibid.*) We view the transaction as a whole; each step is relevant, from the commencement of negotiations to consummation, including "the plain language of the contract, the negotiations which preceded its consummation, the intent of the parties as reflected by their conduct, and the circumstances surrounding the transaction." (See *Foxman v. Commissioner* (1964) 41 T.C. 535, 552, affd., *supra*, 352 F.2d 466 ["the agreement . . . indicates a clear intention . . . to purchase, [the] partnership interest"]; see also *Stilwell v. Commissioner* (1966)

[10] A termination of a partnership for federal tax purposes may be different from its termination, dissolution, or winding-up under state law, and a partnership may continue to exist for federal tax purposes even though state law provides that the partnership has terminated, dissolved, or wound-up. (*Harbor Cove Marina Partners Partnership v. Commissioner* (2004) 123 T.C. 64, 80 (*Harbor Cove*); Treas. Reg. 1.706-1(c)(1).) Appellants do not argue that Bay Shores dissolved and do not provide any evidence of dissolution or filings with the California Secretary of State indicating dissolution.

[11] The liquidation of a partnership occurs upon the earlier of two events: (1) the partnership's termination under IRC section 708(b)(1); or (2) the date upon which the partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its partners). (Treas. Reg. § 1.704-1(b)(2)(ii)(g).)

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46 T.C. 247, 249 [examining language "which usually accompanies a sale, such as 'does hereby transfer, set over, bargain, sell, assign and convey'"].)

Appellants Have Not Established that Bay Shores Technically Terminated in 2012

Appellants provide contrary arguments by asserting that the 2012 distribution was both a liquidating distribution and a sale or exchange causing a technical termination. A liquidation is not considered a "sale or exchange" for the purposes of causing a technical termination. (Treas. Reg. § 1.708-1(a)(b)(2).) Thus, the 2012 distribution cannot be both a liquidating distribution and a sale or exchange causing a technical termination. We also note that Healthcare was sold in 2012, not Bay Shores. Appellant-wife was a partner in Bay Shores; therefore, we examine whether there was a sale or exchange of the partnership interests in Bay Shores, not Healthcare. With regard to Bay Shores, appellants have not provided any evidence that the 2012 distribution was a sale or exchange of her interest or that she otherwise sold or exchanged her interest to another person in 2012. While appellant-wife, a partner with a 2.24 percent interest, received a distribution in 2012, that does not establish that 50 percent of the total interest in Bay Shores' capital and profits were sold or exchanged. Appellants do not provide any contracts, partnership agreements, correspondence, or minutes of meetings to demonstrate whether appellant-wife or any other partner sold or exchanged an interest in Bay Shores' capital and profits.

Appellants stated at the hearing that their 2012 Schedule D does not reflect a sale or exchange of appellant-wife's partnership interest, asserting that "the Schedule D . . . is somewhat defective in this purpose . . . we didn't put the number in Schedule D, so therefore there wasn't a [sale or] exchange. The taxpayer shouldn't be bound by the position they took on the return . . . the facts are that the appellant's interest was exchanged for some cash and some shares in DaVita." Additionally, appellants admit they have "no direct evidence" that Bay Shores terminated in 2012, but assert it is "self-evident." However, the evidence in the record shows otherwise. Bay Shores did not file two short-period returns for 2012 as required following a technical termination: a final return for the short-period ending on the date of the termination, and a short-period return for the new partnership. A partnership that terminates under IRC section 708(b)(1)(B) is required to file a short-year final return for the tax year ending with the date of its termination, and the new partnership is required to file a return for its tax year

beginning after the date of termination of the terminated partnership.[12] (IRS Notice 2001-5.) Here, Bay Shores did not file two short-period returns for 2012 and continued to exist until 2018, when a final K-1 was issued to appellant-wife. Appellants provide no documentation or evidence indicating there was a technical termination.[13] Accordingly, appellants have not shown that Bay Shores experienced a technical termination in 2012.

Termination Due to Cessation of Business Activities

A partnership shall be considered as terminated pursuant to IRC section 708(b)(1)(A), if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. Courts have held that even a nominal amount of continuing business or financial activity precludes a partnership from terminating for federal tax purposes, even when the partnership has abandoned or discontinued its primary business activity. (*Harbor Cove, supra,* 123 T.C. at p. 81.) Cessation of the primary purpose of a partnership is not enough under IRC section 708; there must be a complete cessation of all business. (*Baker Commodities, Inc. v. Commissioner* (1969) 415 F.2d 519, 526.) The partnership is not considered terminated until the only remaining assets are distributed to the partners and all other activity ends, even if operations are limited to winding up the business. (*Ibid.*)

Appellants Have Not Established that Bay Shores Terminated Due to Cessation of Business Activities in 2012

In addition to arguing that Bay Shores technically terminated, appellants argue that Bay Shores terminated due to the cessation of business activities. Appellants cite to *LaRue v. Commissioner* (1988) 90 T.C. 465 (*LaRue*), in which the court held that, where the only activity of the partnership was the defense of a lawsuit, there was a constructive distribution in liquidation of the partner's interests because partnership no longer had any business or assets.

As discussed above, Bay Shores did not terminate in 2012. Additionally, appellants have not shown that the partnership was terminated as a result of the cessation of business activities

[12] Treasury Regulation section 1.708-1(b)(3) provides that a partnership tax year closes with respect to all partners on the date on which the partnership terminates. (IRC, § 443(a)(2); Treas. Reg. 1.706-1(c)(1).) R&TC section 18633(a)(1), provides, in part, that every partnership shall file a partnership return on or before the 15th day of the fourth month following the close of its tax year.

[13] Other effects of a technical termination include that, for instance, depreciation must be restarted on property deemed transferred to the new partnership. (Treas. Reg. § 1.708-1(b)(4); IRC, § 168(i)(7).)

in 2012. We know that Bay Shores continued to exist until 2018 and that, at the least, it existed in anticipation of the receipt of funds dependent on the conclusion of litigation between Healthcare and DaVita. As stated above, only minimal activity is required to keep a partnership from terminating. (See *Harbor Cove, supra,* 123 T.C. at p. 81.) Other than Bay Shores' tax returns and K-1s, no documentary evidence exists in the record from which to determine the extent of Bay Shores' business activities, such as documentation from Bay Shores indicating its activities relating to its primary business purpose. In addition, unlike the circumstances of *LaRue,* Bay Shores retained assets and appellant-wife's interest was not terminated. According to Bay Shores' 2012 tax return, it had total assets of $143,477,961 at the end of the tax year, which included $800,013 in cash. In 2013, Bay Shore made a significant distribution of $459,528 to appellant-wife. And according to Bay Shores' 2014 tax return, it had total assets of $104,346,098 at the end of the tax year, which included $26,663 in cash. In addition, appellant-wife's remaining capital account was not distributed and did not reach zero until the final K-1 in 2018, demonstrating that her interest in the partnership terminated in 2018, not 2012.[14]

Appellants attempt to conflate the sale of Healthcare as the total cessation of Bay Shores' operations, but the facts do not support this theory, as Bay Shores retained assets and cash beyond 2012, made a distribution to appellant-wife in 2013, and was involved in the ongoing Healthcare-DaVita lawsuit in that the outcome could result in significant gain or loss in later years. (See *Harbor Cove, supra,* 123 T.C. at p. 83.) While appellant-wife testified at the hearing that she no longer provided healthcare services under the Healthcare banner after the sale in 2012 (presumably due to her Bay Shores membership), at which time she commenced services as a DaVita employee, a partnership may continue to operate even after it has discontinued its primary business activity. (See *Harbor Cove, supra*, 123 T.C. at p. 81.) Therefore, we find that Bay Shores was not terminated in 2012 due to cessation of business activities.

[14] Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (2) and requirement (3) of this paragraph (b)(2)(ii)(b)), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation). (Treas. Reg. § 1.704-1(b)(2)(ii)(b).)

5. Liquidation of a Partner's Interest in a Partnership

Liquidation Generally

A liquidation of a partner's interest in the partnership occurs upon the earlier of: (1) the date upon which there is a liquidation of the partnership; or (2) the date upon which there is a liquidation of the partner's interest in the partnership under Treasury Regulation section 1.761-1(d). (Treas. Reg. § 1.704-1(b)(2)(ii)(g).) The term "liquidation of a partner's interest" means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership.[15] (IRC, § 761(d); Treas. Reg. §§ 1.731-1(a)(2), 1.761-1(d).) A series of distributions will come within the meaning of this term whether they are made in one year or in more than one year. (Treas. Reg. § 1.761-1(d).) Where a partner's interest is to be liquidated by a series of distributions, the interest will not be considered as liquidated until the final distribution has been made. (*Ibid.*) A distribution which is not in liquidation of a partner's entire interest is a current distribution. (*Ibid.*) Current distributions, therefore, include distributions in partial liquidation of a partner's interest, and distributions of the partner's distributive share. (*Ibid.*)

Whether there is a liquidation of a partner's interest is a question of fact. (*Foxman, supra,* 352 F.2d at p. 469.) In determining whether a transaction constitutes a liquidating distribution, we may look through the form of the transaction to its substance. (*Ibid.*) We view the transaction as a whole; each step is relevant, from the commencement of negotiations to consummation, including "the plain language of the contract, the negotiations which preceded its consummation, the intent of the parties as reflected by their conduct, and the circumstances surrounding the transaction." (*Foxman, supra,* 41 T.C. at p. 552; see also *Beavers v. Commissioner* (1958) 31 T.C. 336 [liquidation found where agreement noted "the termination of the partnership business . . . and liquidation of the partnership interests"].)

Liquidating Distributions with Marketable Securities

Losses are only recognized to the extent of the excess of the partner's basis over the amount of the distribution, when the distribution is in liquidation of a partner's interest in a partnership, and where no property other than money, unrealized receivables, and inventory is

[15] A liquidating distribution of a partner's interest may occur when a partner retires, dies, or otherwise withdraws from a partnership. (IRC, § 736(b)(1).)

distributed. (IRC, § 731(a)(1) & (2).) "Marketable securities are treated as money only for purposes of IRC sections 731(a)(1) and 737." (HR Rep. No. 826, 103d Cong., 2d Sess. 189 n.10, reprinted in 1995-1 CB 250, 259.) "Marketable securities are not treated as money under other provisions, for example, section 731(a)(2)." (*Ibid.*) For purposes of IRC section 731(a)(1) and 737, the term "money" includes marketable securities, and such securities shall be taken into account at their fair market value as of the date of the distribution. (IRC, § 731(c)(1).)[16] Thus, with regard to a current distribution, marketable securities are considered money, and gain can be recognized on a current distribution that includes marketable securities. With regard to a distribution made in liquidation of a partner's interest, however, marketable securities are not considered money, and no loss may be recognized when such a distribution includes marketable securities.[17]

The "DaVita Transaction proceeds schedule" provided by appellants indicates that appellant-wife received DaVita shares valued at $1,331,971, which is the same amount as indicated on the 2012 K-1 under "Distributions of property other than money." Appellants confirmed at the hearing that appellant-wife received money, plus DaVita stock. Therefore, it appears that the distribution included "marketable securities" as defined by IRC section 731(c)(1). As a result, even if the distribution was a liquidating distribution, appellants could not recognize any loss on the distribution because appellant-wife received marketable securities, which is considered property other than money, unrealized receivables, and inventory

[16] As relevant here, the term "marketable securities" means financial instruments which are, as of the date of the distribution, actively traded. (IRC, § 731(c)(2)(A).) Exceptions include when the security was contributed to the partnership by such partner, the property was not a marketable security when acquired by such partnership, or (3) such partnership is an investment partnership and such partner is an eligible partner thereof. (IRC, § 731(c)(3)(A).) The evidence does not indicate that any of the exceptions apply. We note that Bay Shores is not an investment partnership, as indicated on its 2012 Limited Liability Company Return of Income (Form 568).

[17] See Treasury Regulation section 1.731-1(a)(2), Example 2: "Partner B has a partnership interest in partnership BCD with an adjusted basis to him of $10,000. He retires from the partnership and receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is $4,000 cash, real property (used in the trade or business) with an adjusted basis to the partnership of $2,000, and unrealized receivables having a basis to him (under section 732) of $3,000. No loss will be recognized to B on the transaction because he received property other than money, unrealized receivables, and inventory items. As determined under section 732, the basis to B for the real property received is $3,000.

items for the purposes of IRC section 731(a)(2).[18] (See *Neubecker v. Commissioner* (1975) 65 T.C. 577, 584.)

Appellants Have Not Established that the Distribution is a Liquidating Distribution

Even if the 2012 distribution were part of a series of liquidating distributions, appellants would not be able to claim a loss until the final distribution is made, which did not occur until 2018. Where a partner's interest is to be liquidated by a series of distributions, the interest will not be considered as liquidated until the final distribution has been made. (Treas. Reg. 1.761-1(d).) Therefore, because appellant-wife's interest did not terminate until 2018, she would not be able to recognize a loss until 2018, regardless of whether the 2012 distribution was the beginning of a series of liquidating distributions. (See *7050, Ltd v. Commissioner*, T.C. Memo. 2008-112 [court finds minimal activity prevents partnership termination and disallows claimed loss due to liquidating distribution].) Nevertheless, appellants provide no evidence that the 2012 distribution was part of a series of liquidating distributions or part of a plan of liquidation.

In *Tapper v. Commissioner*, T.C. Memo. 1986-597 (*Tapper*), the sale of the partnership's sole asset followed by liquidation were held to be "steps in an integrated transaction," giving rise to a capital loss, pursuant to IRC section 731(a)(2).[19] The sale of the sole asset resulted in complete termination of the partner's interest, and the partnership continued only to wind-up its affairs, which the court found was "part of the process of partnership termination." (*Tapper, supra*.) This determination was based on a partnership agreement which provided that upon the sale of the sole asset, the partnership would be dissolved and liquidated.[20]

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[18] Where a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of his or her interest in the partnership reduced by the amount of any money distributed to him or her in the same transaction. (Treas. Reg. § 1.732-1(b).) Therefore, it appears that the stock would have a basis equal to appellant-wife's remaining basis after reducing the basis by the money distributed.

[19] The court in *Tapper* noted that a loss may be recognized by a partner who receives a distribution in liquidation of his partnership interest, if the distribution consists solely of, inter alia, money, which is not the case in the present appeal. (*Tapper, supra*.)

[20] In *Tapper*, the petitioners argued that the partnership needed to acquire additional assets after the sale in order to satisfy partnership liabilities; however, the court held this point has little significance, as most businesses require time to wind up their affairs after liquidating their assets. (*Tapper, supra*.) The court stated that, after the sale, additional capital was needed in order to satisfy other partnership liabilities before dissolution, which is part of the normal process of terminating a business venture. (*Ibid*.)

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In *Pietz v. Commissioner* (1972) 59 T.C. 207 (*Pietz*), a partnership was formed to build and operate a motel. After the venture was unsuccessful, the motel was sold and the proceeds were applied to the payment of the indebtedness to the bank, which the court found were an "integral part of the plan agreed upon by the partners to liquidate and terminate the unsuccessful partnership."[21] (*Pietz, supra*, 59 T.C. at p. 217.) The court stated that the petitioners "made an agreement with the [partners] for the sale of the property and application of the proceeds in liquidation of the partnership . . . . This was a capital transaction and resulted in a capital loss for tax purposes." (*Pietz, supra*, 59 T.C. at p. 219.)

Unlike in *Tapper* and *Pietz*, appellants provide no partnership arrangements or agreements to establish a plan agreed upon by Bay Shores to liquidate the partnership in 2012 or to show that that the distribution was part of a "process of partnership termination." Appellants provide documents related to the merger agreement between Healthcare and DaVita; however, those documents do not originate from Bay Shores and do not indicate any liquidation of Bay Shores. As previously noted, Healthcare was sold in 2012, not Bay Shores, and the liquidation of Bay Shores is not established by the sale of Healthcare to DaVita.

Appellants provide no evidence from which we may determine that the transaction was a liquidating distribution, such as partnership agreements, contracts, correspondence, or minutes of meetings. However, the evidence in the record indicates that Bay Shores was not in the process of liquidation and termination in 2012. Bay Shores reported assets of $142,677,948 at the end of 2012, and it continued to retain significant assets in later years, reporting assets of $104,346,098 at the end of 2014. Also, as previously discussed, Bay Shores continued to operate and maintain business activity through 2018 and was involved in the ongoing Healthcare-DaVita lawsuit in that the outcome could result in significant gain or loss in later years. Based on appellants' conflicting "alternative arguments," the 2013 return reflecting that appellant-wife's basis was not reduced to zero in 2012 due to a loss from a liquidating distribution (discussed below), and the evidence in the record, it does not appear that there was any contemporaneous intent to treat the distribution as a liquidating distribution for 2012. (See *Foxman, supra*, 352 F.2d at p. 469 [partners "cannot avoid the tax consequences by a hindsight application of principles they now find advantageous to them"].)

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[21] In addition, a second mortgage was issued to two partners. (*Pietz, supra*, 59 T.C. at p. 217.)

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Appellants Have Not Established that They are Entitled to Claim a Loss from a Liquidating Distribution for 2012, pursuant to *Goulder v. Commissioner* (1995) 64 F.3d 663

Appellants argue that *Goulder v. Commissioner* (6th Cir. 1995) 64 F.3d 663 [1995 WL 478595] (*Goulder*) an unpublished decision, supports their position that appellant-wife's distribution from Bay Shores in 2012 should be deemed a liquidating distribution. Appellants contend that Bay Shores' business activity ceased in 2012 and existed beyond 2012 only in anticipation of receiving the remaining escrow amounts at the conclusion of the litigation between Healthcare and DaVita.
Accordingly, appellants contend that while Bay Shores did not terminate until 2018, the loss should be recognized in 2012 as a liquidating distribution. Appellants argue that the facts of this appeal reflect those described in *Goulder*, where the petitioner was granted a loss arising from a liquidating distribution, pursuant to IRC section 731(a)(2), even though the partnership retained funds yet to be distributed to the partners.

In *Goulder*, the partnership, which rented apartments to tenants, distributed all of its assets in the year in question except for tenant security deposits that were distributed to the partners in the following year. The court held that "there is no per se rule that the mere retention of certain assets or management of particular activities in anticipation of liabilities amounts to a continuation of a partnership."[22] (*Goulder, supra*, 64 F.3d 663.) Thus, the court in *Goulder* held that a loss may not be deferred where the partnership continues due to the retention of certain assets or the management of particular activities in anticipation of liabilities.

However, the court in *Goulder* determined that the loss was allowed due to a joint stipulation filed by the petitioner and the Internal Revenue Service that "the Partnership neither operated or carried on any business, financial operation, or venture, having ceased any such activity prior to the beginning of such year." Due to this stipulation, the court found that the partnership terminated prior to the distribution of the security deposits retained by the partnership. Specifically, the court in *Goulder* concluded that: "Simply stated, one cannot be a partner in, have an interest in, or receive proceeds from, a partnership that does not exist."

[22] Appellants assert that, when a series of distributions are part of an integrated, overall plan of complete liquidation, every distribution is in complete liquidation regardless of whether the entity is completely dissolved or a final return has been filed, citing *Olmstead v. Commissioner*, T.C. Memo. 1984-381. We note that *Olmstead* involved the liquidation of a corporation, not a partnership, and cites to IRC section 332, which involves a "plan of liquidation." We note that, nevertheless, appellants have not provided any evidence of a plan of liquidation.

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In the present appeal, there is no such determination or stipulation that Bay Shores terminated in 2012, and the facts do not demonstrate that Bay Shores terminated in 2012. The loss in *Goulder* was allowed in the year of termination because "one cannot be a partner in, have an interest in, or receive proceeds from, a partnership that does not exist." Here, there was no termination of Bay Shores in 2012 and it continued to exist until 2018.[23] Thus, *Goulder* is not applicable to the facts of this appeal and the alleged loss cannot be allowed in 2012.

6. Duty of Consistency

Duty of Consistency

The duty of consistency, like the doctrine of judicial estoppel, '"precludes a party from gaining an advantage by taking one position, and then seeking a second advantage by taking an incompatible position.'" (*Estate of Ashman v. Commissioner* (9th Cir. 2000) 231 F.3d 541, 543, quoting *Rissetto v. Plumbers & Steamfitters Local 343* (9th Cir. 1996) 94 F.3d 597, 600.) The duty of consistency contributes to the finality and repose of the statute of limitations by holding taxpayers to the reporting of an item in a closed year. (*Estate of Ashman v. Commissioner*, T.C. Memo. 1998-145, affd. (9th Cir. 2000) 231 F.3d 541.) The duty of consistency requires a showing of three elements: (1) a representation or report by the taxpayer; (2) on which FTB has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm FTB. (*Appeal of Chen and Chi*, 2020-OTA-021P.)[24] The duty of consistency does not apply when the inconsistency concerns a pure question of law and both the taxpayer and FTB had equal access to the facts. (*Herrington v. Commissioner* (5th Cir. 1988) 854 F.2d 755, 758.)

Appellants' Inconsistent Positions in 2012 and 2013

If appellants treated the 2012 distribution as a liquidating distribution resulting in a loss to the extent that appellant-wife's remaining basis exceeds the distribution, appellant-wife's basis would have been reduced to zero at the end of 2012. However, appellant-wife did not report or pay tax on the distribution of $459,528 in 2013. As previously noted, a distribution of gain is

[23] For example, appellant-wife received a distribution from Bay Shores in 2013, an act which conflicts with the facts and reasoning in *Goulder*.

[24] Precedential opinions of the Office of Tax Appeals (OTA) may be found on OTA's website at: < https://ota.ca.gov/opinions >.

recognized to the extent the money distributed exceeds the partner's basis immediately before the distribution. (IRC, § 731(a)(1).) Thus, if appellant-wife's basis was zero in 2013, then appellant-wife should have reported a gain and paid tax on the distribution of $459,528 in 2013.[25] This indicates that there was no contemporaneous intent to treat the distribution as a liquidating distribution resulting in a loss which reduced appellant-wife's basis to zero. Additionally, this indicates that, due to the treatment of the 2012 distribution as if it was not a loss that reduced her basis to zero, appellant-wife received a benefit in 2013 by escaping taxation on the 2013 distribution.

Appellants are Estopped from Claiming a Loss from the 2012 Distribution

As noted above, by failing to report any gain from the 2013 distribution, in our view, appellant-wife represented that the 2012 distribution was not a liquidating distribution resulting in a loss. (See *Estate of Letts v. Commissioner* (1997) 109 T.C. 290, 299 ["a failure to report income may be an implied statement of the facts relating to the taxpayer's receipt of the funds"].) FTB relied on the representation when appellant-wife filed the 2013 return and FTB accepted the return and allowed the statute of limitations to expire.[26] Appellants now attempt to recharacterize a representation in a closed year in order to receive a second advantage in an open year. Appellants' inconsistent representation as to whether a distribution is a liquidating distribution is a question of fact. (*Foxman, supra*, 352 F.2d at p. 469, citing *Cleveland v. Commissioner* (3d. Cir. 1964) 335 F.2d 473, 477.) Additionally, appellants and FTB did not have equal access to the facts because appellant-wife was a partner in Bay Shores, a position where the necessary facts were available. (See *Crosley Corp. v. United States* (6th Cir. 1956) 229 F.2d 376, 381.) Appellants may not benefit from a position taken in a closed year and a contrary position taken in an open year which would result in the improper avoidance of tax. Accordingly, appellants must be held to the representation made on the 2013 return and they are

[25] The 2013 K-1 also indicates "interest income" of $255 and deductions of $931 (i.e., "2001 LLC fees" of $264, "accounting fees" of $595, "bank charges" of $25, "interest charges" of $2, and "legal fees" of $45).

[26] In general, FTB must issue an NPA within four years of the date the taxpayers filed their California return. (R&TC, § 19057.) Appellants indicate that they also filed their 2018 return consistent with the K-1s and returns for 2012 and 2013 (i.e., inconsistent with their new liquidating distribution theory); however, the statute of limitations is still open for FTB to issue an NPA for 2018, and therefore the duty of consistency does not apply based on the 2018 tax year.

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estopped from claiming the 2012 distribution as a liquidating distribution that results in a loss to the extent that appellant-wife's remaining basis exceeds the distribution.

## HOLDING

The reported distributive share of capital gains totaling $9,461,508 from Bay Shores may not be reduced by $4,250,000, which is appellant-wife's claimed basis in Bay Shores.

## DISPOSITION

FTB's action is sustained.

DocuSigned by:
Josh Lambert
B90E40A720E3440...
Josh Lambert
Administrative Law Judge

We concur:

DocuSigned by:
John O Johnson
873D9797B9E64E1...
John O. Johnson
Administrative Law Judge

DocuSigned by:
Daniel Cho
7B28A07A7E0A43D...
Daniel K. Cho
Administrative Law Judge

Date Issued: 3/26/2020