St. John's Law Review

Volume 26, May 1952, Number 2 Article 21

Vindication of Family Partnerships

St. John's Law Review

Recommended Citation

St. John's Law Review (1952) "Vindication of Family Partnerships," *St. John's Law Review*: Vol. 26 : No. 2 , Article 21.
Available at: https://scholarship.law.stjohns.edu/lawreview/vol26/iss2/21

that funds which are actually needed for expansion or reserve purposes will be distributed. The loss to the corporation of the use of these funds must surely act to throttle business expansion and effect productive employment.[108]

Fortunately, however, the statute has been administered in an unusually tolerant manner.[109] Much of the fear created within the ranks of corporate managers by a strict reading of the statute has been dissipated by the temperate attitude of the courts and the Commissioner. The courts have adopted a generous interpretation of the "reasonable needs" of a business[110] and have been reluctant to substitute their judgment for that of the directors.[111] In addition, the decisions have carefully circumscribed the discretion of the tax authorities in their enforcement of the statute.[112] In a similarly moderate manner, the Commissioner has sought to apply the penalty only when ". . . a *common-sense view* of the whole picture makes it reasonably clear that there was a tax avoiding purpose, and that the reasons alleged for the accumulation are not reliable or sufficient."[113] The small number of deficiency letters issued annually under the section,[114] and the failure to bring before a court even one corporation whose stock and control were both widely dispersed,[115] point up the limited enforcement measures undertaken by the Commissioner. In short, a wise administrative policy has prevented Section 102 from becoming either a present threat to business or an insurmountable obstacle in the path of a growing enterprise.

VINDICATION OF FAMILY PARTNERSHIPS

The definition of "partner," as amplified by a recent amendment to Section 3797(a)(2) of the Internal Revenue Code, now includes a person who ". . . owns a capital interest in a partnership in which

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108 See note 93 *supra*.

109 See Cary, *supra* note 93, at 220.

110 See Cary, *supra* note 15, at 1306. For examples of generous interpretations of business needs, see J. L. Goodman Furniture Co., 11 T. C. 530 (1948); Lion Clothing Co., 8 T. C. 1181 (1947). A more restricted interpretation may be found in World Publishing Co. v. United States, 169 F. 2d 186 (10th Cir. 1948).

111 R. C. Tway Coal Sales Co. v. United States, 3 F. Supp. 668 (W. D. Ky. 1933), *aff'd*, United States v. R. C. Tway Coal Sales, 75 F. 2d 336 (6th Cir. 1935); Lane Drug Co., 3 CCH 1944 TC Mem. Dec. 394 (1944).

112 See Cary, *supra* note 15, at 1307.

113 Miller, *Improper Accumulation of Surplus—(2) The Lawyer's Task of Giving Advice as to Current Dividend Policy, in View of Section 102 I.R.C.*, 1 Amer. Univ. Tax Inst. Lectures 103, 110 (1948).

114 During the period from 1939 to 1947 less than 100 deficiency letters were issued annually under the section. *Id.* at 111.

115 Covers the period from 1913 to 1950. See Buck and Shackelford, *supra* note 89, at 337.

capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person." [1] A new section of the Code, Section 191, permits a donee of a partnership interest to include within his taxable income his distributive share of the partnership earnings, except where that amount is disproportionate to the donor's share, based on the capital contribution or services of each.[2] This latter section also provides that an intra-family transfer of a partnership interest shall be considered a gift, and the fair market value thereof treated as donated capital.[3] "Family" has been defined to mean the ancestors, spouse, and lineal descendants of a person, or a trust created for the primary benefit of these individuals.[4]

Prior to the Revenue Act of 1951, there was considerable confusion as to the exact status of the family partnership [5] in the scheme of federal taxation. Some decisions were based on tax considerations, while others rested on ownership of the partnership interest.

The Tax Aspect

Courts have tried to enforce federal tax laws uniformly, recognizing the basic principle that income should be taxed to the person earning ". . . the right to receive it and enjoy the benefit of it when paid." [6] A family partnership formed solely to avoid taxes could de-

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[1] Revenue Act of 1951, § 340, 65 STAT. 511 (1951).

[2] "In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital." INT. REV. CODE § 191.

[3] "For the purpose of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital." *Ibid.*

[4] *Ibid.*

[5] One advantage of this form of organization is the opportunity it gives a parent to divide his income among members of his family, who are then taxed on their shares. INT. REV. CODE § 181; *accord,* United States v. Kaufman, 267 U. S. 408 (1925); *cf.* Scherf v. Commissioner, 161 F. 2d 495 (5th Cir. 1947). Thus, since the total tax paid on all the shares is less than the tax on the original single income unit [see INT. REV. CODE §§ 12(b), 400], a larger net income remains within the family.

The importance of the husband-wife partnership as a convenient means of reducing taxes has been decreased since 1948 by INT. REV. CODE § 12(d). Family partnerships are still useful, however, as a means of splitting income among members of the family other than the spouse. See ALEXANDER, FEDERAL TAX HANDBOOK § 1703 (Speisman ed. 1952).

[6] Helvering v. Horst, 311 U. S. 112, 119 (1940); *cf.* Lucas v. Earl, 281 U. S. 111, 112 (1930) (The usual taxpayer is the actual income-earner.); *accord,* Commissioner v. Culbertson, 337 U. S. 733, 739 (1949); Doll v. Com-

feat this principle[7] by causing the tax to be paid by the alleged partners rather than the real producer and owner of the income.[8] Therefore, the Commissioner and the courts have gone beyond mere form, and have sought to determine the substance of the transaction.[9] Of the many factors which have been considered in determining the validity of a partnership, the elements apparently deemed most essential have been an "original capital" contribution,[10] performance of "vital services,"[11] or a combination of both.[12] The nature of the

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missioner, 149 F. 2d 239 (8th Cir. 1945); *see* Blair v. Commissioner, 300 U. S. 5, 11 (1937). But the donor who enjoys the personal satisfaction of giving has been taxed as if it were his income. *Accord,* Helvering v. Clifford, 309 U. S. 331 (1940); *cf.* Commissioner v. Tower, 327 U. S. 280, 292 (1946); Helvering v. Horst, *supra* at 118; Blair v. Commissioner, *supra* at 12; Batman v. Commissioner, 189 F. 2d 107 (5th Cir. 1951); Kohnstamm v. Pedrick, 153 F. 2d 506 (2d Cir. 1945); see Note, 164 A. L. R. 1144, 1147 (1946); Bruton, *Family Partnerships and The Income Tax—The Culbertson Chapter,* 98 U. of Pa. L. Rev. 143, 161 (1949).

[7] ". . . [T]he family partnership is looked upon with suspicion and is subjected to special scrutiny to prevent tax avoidance." Nelson v. Commissioner, 184 F. 2d 649, 651 (8th Cir. 1950); *accord,* Kent v. Commissioner, 170 F. 2d 131 (6th Cir. 1948); *cf.* Mauldin v. Commissioner, 155 F. 2d 666 (4th Cir. 1946); Bentley v. Commissioner, 14 T. C. 228, *aff'd,* 184 F. 2d 668 (2d Cir. 1950); see Note, 164 A. L. R. 1144, 1147 (1946). Where there is also an intent to diminish one's taxes, the courts are "influenced" as to the significance of the other facts. Elrod, *Husband and Wife or "Family" Partnerships,* 20 Ind. L. J. 65, 68 (1944). *But cf.* Commissioner v. Culbertson, 337 U. S. 733, 747 (1949); Hardymon v. Glenn, 56 F. Supp. 269, 273 (W. D. Ky. 1944); Thornton v. Commissioner, 5 T. C. 116, 124 (1945).

[8] The wife is taxed on income chiefly due to the husband's industry, while he reports a greatly reduced amount of taxable income. If the wife must buy necessaries, she is not the real owner of her share, since the husband has conditioned his gift to her.

[9] *Accord,* Commissioner v. Culbertson, 337 U. S. 733 (1949); Helvering v. Clifford, 309 U. S. 331, 335 (1940); Economos v. Commissioner, 167 F. 2d 165 (4th Cir. 1948); Doll v. Commissioner, 149 F. 2d 239 (8th Cir. 1945); Mead v. Commissioner, 131 F. 2d 323 (5th Cir. 1942); *cf.* Scharff v. Henslee, Civil Nos. 962, 1182 (M. D. Tenn., Nov. 7, 1951), 4 P-H 1952 Fed. Tax Serv. ¶72,291 (1952); Byerly v. Commissioner, 154 F. 2d 879 (6th Cir. 1946); see Note, 25 Notre Dame Law. 134, 137 (1949).

[10] *Cf.* Miller v. Commissioner, 183 F. 2d 246 (6th Cir. 1950); Fletcher v. Commissioner, 164 F. 2d 182 (2d Cir. 1947); Singletary v. Commissioner, 155 F. 2d 207 (5th Cir. 1946); Vaughan v. Carey, 88 F. Supp. 967 (N. D. Ohio 1949); Drew v. Commissioner, 12 T. C. 5 (1949); Kuzmick v. Commissioner, 11 T. C. 288 (1948).

[11] *Cf.* Commissioner v. Tower, 327 U. S. 280 (1946); Feldman v. Commissioner, 186 F. 2d 87 (4th Cir. 1950); LeSage v. Commissioner, 173 F. 2d 826 (5th Cir. 1949); Wilson v. Commissioner, 161 F. 2d 661 (7th Cir. 1947); Tinkoff v. Commissioner, 120 F. 2d 564 (7th Cir. 1941); Bentley v. Commissioner, 14 T. C. 228, *aff'd,* 184 F. 2d 668 (2d Cir. 1950); Harmon v. Commissioner, 13 T. C. 373 (1949); Jennings v. Commissioner, 10 T. C. 505 (1948); Rosenberg v. Commissioner, 7 T. C. 73 (1946).

[12] *Cf.* Barrett v. Commissioner, 185 F. 2d 150 (1st Cir. 1950); Collamer v. Commissioner, 185 F. 2d 146 (4th Cir. 1950); Ginsburg v. Arnold, 176 F. 2d 879 (5th Cir. 1949); Graber v. Commissioner, 171 F. 2d 32 (10th Cir. 1948); Canfield v. Commissioner, 168 F. 2d 907 (6th Cir. 1948); Arnold v. Schepps,

test to be applied was crystallized in *Commissioner v. Culbertson,*[13] in which the query was said to be whether ". . . upon a consideration of all facts . . . the partners joined together in good faith to conduct a business . . . ."[14] The primary concern of the courts following this reasoning was whether the intent of the parties was to decrease their tax[15] rather than whether the resulting association was a partnership in fact.[16]

The Property Approach

Other courts, in considering family partnerships from the viewpoint of the laws of property, applied local state laws to determine the status of the income,[17] or the legal rights and interests created.[18] The federal revenue laws were then applied to the interests thus ascertained.[19] The principal issue before these courts was whether the transfer of interest was valid so as to constitute the recipient the owner.[20] Thus, where the interest in a partnership was trans-

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166 F. 2d 821 (5th Cir. 1948); Scherf v. Commissioner, 161 F. 2d 495 (5th Cir. 1947); Singletary v. Commissioner, 155 F. 2d 207 (5th Cir. 1946); Boylin v. Commissioner, 14 T. C. 542 (1950); Harkness v. Commissioner, 13 T. C. 1039 (1949); Morrison v. Commissioner, 11 T. C. 696 (1948); McIntyre v. Commissioner, 37 B. T. A. 812 (1938).

[13] 337 U. S. 733 (1949).

[14] "If, upon a consideration of all the facts, it is found that the partners joined together in good faith to conduct a business, having agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits, that is sufficient." *Id.* at 744. *Cf.* Miller v. O'Malley, 89 F. Supp. 697, 701 (D. Neb. 1950).

[15] *See* Alexander v. Commissioner, Civil No. 13482 (5th Cir., March 6, 1952), 4 P-H 1952 FED. TAX SERV. ¶72,337 (1952). *But cf.* Thornton v. Commissioner, 5 T. C. 116 (1945). "Mere purpose to avoid tax does not in itself vitiate a transfer of property." *Id.* at 124.

[16] The "business purpose doctrine" ". . . seems to contemplate that the wife must render substantial and valuable services or add needed capital or credit to the business in order to be considered a partner for income tax purposes." Note, 164 A. L. R. 1144, 1153 (1946).

[17] Black v. Commissioner, 114 F. 2d 355 (9th Cir. 1940).

[18] *Accord,* United States v. Hutcherson, 188 F. 2d 326 (8th Cir. 1951); Harvey v. United States, 185 F. 2d 463 (7th Cir. 1950); Shaw v. United States, 94 F. Supp. 245 (W. D. Mich. 1939); *cf.* Blair v. Commissioner, 300 U. S. 5, 12 (1937); *see* Helvering v. Clifford, 309 U. S. 331, 342 *et seq.* (1940) (dissenting opinion); see Mannheimer and Mook, *A Taxwise Evaluation of Family Partnerships,* 32 IOWA L. REV. 436, 451 (1947).

[19] Trapp v. United States, 177 F. 2d 1 (10th Cir. 1949); Irrgang v. Fahs, 94 F. Supp. 206 (S. D. Fla. 1950); *cf.* Commissioner v. Harmon, 323 U. S. 44 (1944); Blair v. Commissioner, 300 U. S. 5, 11 (1937).

[20] *Cf.* Giffen v. Commissioner, 190 F. 2d 188 (9th Cir. 1951); Yiannias v. Commissioner, 180 F. 2d 115 (8th Cir. 1950); Kohl v. Commissioner, 170 F. 2d 531 (8th Cir. 1948). *But cf.* Gregory v. Helvering, 293 U. S. 465 (1934) (Corporate reorganization, which fully complied with the statute, held ineffective as to taxpayer, since the entire scheme was evolved to avoid taxes rather than to effect the purported reorganization. The "business purpose" rule

ferred by gift, unless such gift was complete and effective by state law,[21] there was no valid partnership.[22] Following this approach, these courts made substantial compliance with local law a prerequisite for recognition of family partnerships for federal tax purposes.[23]

The refusal of the courts to follow one line of reasoning consistently, led to serious instability in the law. Federal courts were holding family partnerships invalid for federal tax purposes where the same partnerships would be valid under the local state law,[24] and vice versa.[25] There was great need for someone ". . . to make crystal clear that there is no special concept of 'partnership' for tax purposes . . . ." [26] This is the intent and aim of the new statutes.[27]

Effect of the New Definition

The chief effect of Section 3797(a)(2) is to reduce the issues, in determining the validity of a partnership, to the one question of ownership.[28] The former tests of "original capital" contribution, or of "vital services" are superseded.[29] Thus, were a taxpayer to give

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enunciated and applied in the *Gregory* case was later extended to family partnerships.).

[21] See Morgan v. Commissioner, 309 U. S. 78 (1940). "State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed." *Id.* at 80. The New York view on the essential elements of a valid gift may be found in Vincent v. Putnam, 248 N. Y. 76, 161 N. E. 425 (1928); Petition of McCredy, 274 App. Div. 363, 83 N. Y. S. 2d 806 (3d Dep't 1948), *appeal denied*, 299 N. Y. 799, 85 N. E. 2d 795 (1949); *In re* Dobish's Will, 98 N. Y. S. 2d 838 (Surr. Ct. 1950); *In re* Giovannozzi's Estate, 57 N. Y. S. 2d 528 (Surr. Ct. 1945).

[22] *Cf.* Batman v. Commissioner, 189 F. 2d 107 (5th Cir. 1951); Miller v. Commissioner, 183 F. 2d 246, 253 (6th Cir. 1950); Ellery, 4 T. C. 407, 412 (1944); Britt's Estate v. Commissioner, 190 F. 2d 946, 951 (5th Cir. 1951).

[23] See note 19 *supra;* see Giffen v. Commissioner, 190 F. 2d 188 (9th Cir. 1951); Weizer v. Commissioner, 165 F. 2d 772 (6th Cir. 1948); Commissioner v. Tenney, 120 F. 2d 421 (1st Cir. 1941); Kier, 15 B. T. A. 1114 (1931); Bartley, 4 B. T. A. 874 (1931); Newell, 17 B. T. A. 93 (1929); ALEXANDER, FEDERAL TAX HANDBOOK § 1701 (Speisman ed. 1952).

[24] See Durwood v. Commissioner, 159 F. 2d 400 (8th Cir. 1947); Doll v. Commissioner, 149 F. 2d 239 (8th Cir. 1945); Note, 164 A. L. R. 1144, 1156 (1946).

[25] See Smith v. Henslee, 173 F. 2d 284 (6th Cir. 1949); Schroder v. Commissioner, 134 F. 2d 346 (5th Cir. 1943); Commissioner v. Barnes' Estate, 30 F. 2d 289 (3d Cir. 1929); Parker, 6 T. C. 974 (1946); Note, 164 A. L. R. 1144, 1158 (1946).

[26] Commissioner v. Culbertson, 337 U. S. 733, 754 (1949) (dissenting opinion).

[27] The purpose of the bill is ". . . to harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business." U. S. Code Cong. Serv., Sp. Rev. Pamph. 3089, 3128 (1951) (Senate Report); *id.* at 2901, 2933 (House Report).

[28] U. S. Code Cong. Serv., Sp. Rev. Pamph. 3089, 3128 (1951) (Senate Report); *id.* at 2934 (House Report).

[29] "If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of the new partner." *Ibid.*

his wife shares of stock on condition that she invest them in a partnership, as was the situation in *Commissioner v. Tower*,[30] the court should still decide against the taxpayer. Today, however, the attempted transfer would not give rise to a partnership because the "gift" is conditional. The emphasis which this case placed upon "original capital" was criticized in *Commissioner v. Culbertson*,[31] which said the question to be determined was whether the parties had intended to associate for the "... present conduct of the enterprise." [32] This latter test, itself, was criticized [33] as negating the rule that the economic source of the income is to be taxed; now the test appears obsolete.[34] The only issue to be decided today is whether the purported partner actually owns his interest.[35] The fact that the interest resulted from a gift—long the source of litigation [36] with the

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[30] 327 U. S. 280 (1946) (Taxpayer gave his wife shares of stock on condition that she contribute the assets represented by the stock into a new partnership. The corporation was liquidated and the partnership took over its business. The taxpayer retained control of the business, in which his wife was a limited partner, and used her income for family expenses. The Court held that there was no partnership as no substantial change in the relation of the parties to the income had been made.).

[31] 337 U. S. 733, 741 (1949).

[32] "The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Id.* at 742.

[33] Bruton, *supra* note 6, at 156. "If intent to create such an arrangement [see note 32 *supra*] is an intent to create a partnership within the meaning of the revenue law, then the *Clifford-Horst* doctrine of economic source of the income as a test of taxability seems to have gone by the board in partnership cases." *Ibid.*

[34] See note 29 *supra*. "The concept that a special business purpose must be the motive for the creation of a partnership interest, should now be eliminated completely." Packel, *The Next Inning of Family Partnerships*, 100 U. of Pa. L. Rev. 153, 158 (1951). But see Int. Rev. Bu. Mim. 6767 (February 19, 1952), 4 P-H 1952 Fed. Tax Serv. ¶76,179 (1952) (Presence of a tax-avoidance motive is not to be ignored, but is to be one of the many factors determining the validity of the intrafamily gift); Schallerer, Civil No. 24, 175 (T. C., March 7, 1952), 4 P-H 1952 Fed. Tax Serv. ¶74,363 (1952).

[35] "The amendment leaves the Commissioner and the courts free to inquire in any case whether the donee or purchaser actually owns the interest in the partnership which the transferor purports to have given or sold him." U. S. Code Cong. Serv., Sp. Rev. Pamph. 3089, 3129 (1951) (Senate Report); *id.* at 2934 (House Report).

[36] See Commissioner v. Culbertson, 337 U. S. 733 (1949); Commissioner v. Tower, 327 U. S. 280 (1946); Morgan v. Commissioner, 309 U. S. 78 (1940); Phillips v. United States, 193 F. 2d 132 (5th Cir. 1951); Miller v. Commissioner, 183 F. 2d 246 (6th Cir. 1950); Kohl v. Commissioner, 170 F. 2d 531 (8th Cir. 1948); Scherf v. Commissioner, 161 F. 2d 496 (5th Cir. 1947); Rose v. Commissioner, 65 F. 2d 616 (6th Cir. 1933).

Commissioner—apparently is immaterial to the decision.[37]

The Committee Reports accompanying the new statutes refer to the confused state of the law manifested in the *Tower* and *Culbertson* cases. Whether these cases caused or merely added to the disorder was deemed irrelevant;[38] the important matter was that confusion did exist. A large part of this disorder was due to the refusal of many courts to apply local property law.[39] While the new statute was aimed at clarifying the law, the enactments do not purport to be a new law of property for the nation. It is unnecessary to choose this latter construction in order to rectify the interrelation of partnership and tax law. The absence in the amendment of any indication to the contrary, coupled with the facts that this approach will eliminate much of the former confusion,[40] and that there exists favorable judicial precedent for this view,[41] combines to make the conclusion almost inevitable that local law should determine the interests, and the revenue laws be then applied.[42] By employing this reasoning, the federal laws can be applied uniformly where the taxable interest exists; and the tendency among states to adopt uniform laws[43] assures that the legal interests resulting in similar fact situations will be the same in the several states.

The language of Section 3797 does not expressly limit the effect of the statute to cases of family partnerships; rather the words of the amendment seem applicable to all partnerships. This would be in accord with the congressional intent to harmonize the law regarding partnerships. Therefore, where *any* partnership fits the statutory definition, regardless of how the partner acquired his interest, if he is the real owner of that interest, he is a true partner, and taxable on his share of the profits.[44]

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[37] The legislation was intended ". . . to make clear the fundamental principle that, where there is a real transfer of ownership, a gift of a family partnership interest is to be respected for tax purposes without regard to the motives which actuated the transfer. . . ." U. S. Code Cong. Serv., Sp. Rev. Pamph. 3089, 3130 (1951) (Senate Report); *id.* at 2935 (House Report). See note 34 *supra*.

[38] U. S. Code Cong. Serv., Sp. Rev. Pamph. 3089, 3129 (1951) (Senate Report); *id.* at 2934 (House Report).

[39] See notes 24, 25 *supra*.

[40] See note 29 *supra*.

[41] See note 23 *supra*.

[42] The prerequisites for such a conclusion, as established in Doll v. Commissioner, 149 F. 2d 239 (8th Cir. 1945), appear satisfied: the objective sought necessarily implies that the cause of the prior confusion, a non-recognition of local property law, be abolished. In addition, the uniform application of the federal tax scheme will not be interfered with nor defeated by such conclusion.

[43] See 7 U. L. A. xv (1949) (Table III).

[44] See Packel, *supra* note 34. "The provision is a direction as to a particular situation in which a family partnership should be recognized, and it does not purport to exclude other situations from being similarly recognized." *Id.* at 160.

Reallocation Under Section 191

The primary effect of the new Section 191 is to permit the Commissioner to reallocate partnership income received by the donee of a partnership interest. Assume, for example, that the donee of a 40% interest received 80% of the profits, despite the fact that the donor, who retained the 60% interest, performed most of the essential services. The Commissioner, in such a case, may refuse to allow the donee to include as his taxable income that share of profits which reasonably belongs to the donor.[45] Since the donee may not report this sum, it will be attributed and taxed to the donor. The effect would be to compel erstwhile partners to distribute the profits equitably. The disparity in the shares of the partners should be apparent as of the execution of the partnership agreement. Where later economic changes bring about the discrepancy, the power to reallocate may not be exercised.[46]

The effect of Section 191, regarding reallocation, is not expressly limited to family partnerships, since the words of the statute refer to ". . . the case of any partnership interest created by gift. . . ."[47] Some have interpreted this provision loosely, so as to include cases in which the interest was not created by gift.[48] The statute, however, is specific,[49] and since the primary goal of the section is obviously to implement Section 3797, which, in defining partners, says nothing about altering the profit-sharing arrangement,[50] the statutory limitation should be enforced. Even if the donee is not a family member, as defined in Section 191, the reallocation provision would seem applicable. But if the interest were not obtained by gift, or from another member of the family—in which case it is presumed a gift under Section 191 [51]—it is submitted that Section 191 will not apply. There are several reasons for this conclusion. First, the section expressly refers to an interest created by gift, and neither the statute nor the

[45] See note 2 *supra*. ". . . [T]he bill provides that in the case of any partnership interest created by gift the allocation of income, according to the terms of the partnership agreement, shall be controlling for income tax purposes except when the shares are allocated without proper allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the allocation to the donated capital is proportionately greater than that attributable to the donor's capital." Reallocation is allowed in the latter case. U. S. Code Cong. Serv., Sp. Rev. Pamph. 3089, 3130 (1951) (Senate Report); *id.* at 2935 (House Report); see INT. REV. BU. Mim. 6767 (February 19, 1952), 4 P-H 1952 FED. TAX SERV. ¶ 76,179 (1952).

[46] See Packel, *supra* note 34, at 164.

[47] See notes 2, 45 *supra*.

[48] Packel, *supra* note 34. Section 191, it is said, will apply whether the interests be in new or existing partnerships, ". . . and whether or not it is contended that the case presents no element of gift or purchase of a partnership interest." *Id.* at 163.

[49] See notes 2, 45 *supra*.

[50] See note 1 *supra*.

[51] See note 3 *supra*.

Committee Reports indicate an intent that it should be applied otherwise.[52] The presumption that a transfer of interest was by gift is specifically related to Section 191, and applies only to members of a family; [53] hence there is no presumption that a transfer between other than family members was by gift. Second, there is no great necessity for reapportioning partners' income where the parties are strangers. Since the partnership contract is a business arrangement, the parties can, and should, be expected to deal with eyes open and at arm's length in its execution. When the partners are members of the same family, a different situation exists, and the ordinary rules of business should be modified.[54]

Family Defined

As indicated previously,[55] Section 191 expressly states who are the members of one's family. This clause is not expressly applied nor apparently limited to Section 191 of the Code,[56] as is the clause relative to the presumption of gift. Since Section 3797 does not state who, as owners of capital interests, may be partners,[57] confusion may result. It is submitted that the limitation of "family," as found in Section 191, should be applied to define what persons will be recognized under Section 3797 as members of a family partnership. This would tend to effectuate the congressional plan of simplifying the law, by removing any doubt caused by the indefiniteness of Section 3797. One could then be certain that a wife, a child, a parent or a trust would be recognized as a true member of a valid family partnership.

Not only one's spouse, but also a person's ancestors and lineal descendants may join him in a family partnership.[58] The claim that a child, especially a minor child, is a partner may well cause difficulty. The problem that arises when some partners are children revolves around the actual ownership of the interest given them.[59] While the

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[52] See notes 2, 45 *supra.*

[53] See note 3 *supra.*

[54] "The same standards apply in determining the bona fides of alleged family partnerships as in determining the bona fides of other transactions between family members." But these intrafamily transfers ". . . whether or not involving partnership interest, afford much opportunity for deception and should be subject to close scrutiny." U. S. Code Cong. Serv., Sp. Rev. Pamph. 3089, 3129 (1951) (Senate Report); *id.* at 2934 (House Report).

[55] See text at note 4 *supra.*

[56] The last sentence of the new Section 191 reads: "The 'family' of any individual shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons."

[57] See text at note 1 *supra.*

[58] See note 56 *supra.*

[59] ". . . [H]owever, the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, *if he is the real owner.*" (italics added). U. S. Code Cong. Serv., Sp. Rev. Pamph. 3089, 3128 (1951) (Senate Report); *id.* at 2934 (House Report).

donor may retain some control over the donated interest,[60] a point can be reached where the amount of power withheld is so great that it negates the idea of a gift [61] since a conditional gift is invalid.[62] The matter is further complicated by the fact that the donor may be a general partner, and the donee a limited partner.[63] The difficulty can only be resolved by looking at all aspects of the transaction including the mental age and ability of the child, the parental control exercised, and the ability of the child to manage his interest contrary to the preference of the parent-donor.[64]

The donor's ability to create a trust for the benefit of his spouse, children, or ancestors, may help alleviate the problem of validity of ownership of the interest by a child. Where such a trust is a member of a family partnership, it will be considered a partner dependent upon the ownership of its interest, and the use of the income.[65] There is no prohibition against the settlor naming himself trustee,[66] there may even be cases in which the husband-donor is himself a partner, and the other partner is a trust of which he is the trustee.[67] Needless to say, a searching inquiry would be essential to determine

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[60] *Accord,* Phillips v. United States, 193 F. 2d 132 (5th Cir. 1951); Whayne v. Glenn, 59 F. Supp. 517, 524 (W. D. Ky. 1945); *In re* Nisbet's Will, 199 N. Y. 569, 96 N. E. 1135 (1910), *affirming* 139 App. Div. 1, 123 N. Y. Supp. 414 (1st Dep't 1910); *In re* Green's Estate, 247 App. Div. 540, 288 N. Y. Supp. 249 (4th Dep't 1936); *In re* Blum's Estate, 43 N. Y. S. 2d 771 (Surr. Ct. 1943).

[61] ". . . [W]here . . . the benefits directly or indirectly retained blend so imperceptibly with the normal concepts of full ownership, we cannot say that the triers of fact committed reversible error when they found that the husband was the owner. . . ." Helvering v. Clifford, 309 U. S. 331, 336 (1940). *Cf.* Helvering v. Horst, 311 U. S. 112, 119 (1940); *In re* Humphrey's Estate, 191 App. Div. 291, 181 N. Y. Supp. 169 (1st Dep't 1920); *In re* Hegeman's Estate, 38 N. Y. S. 2d 762 (Surr. Ct. 1942); see Note, 164 A. L. R. 1144, 1164 (1946).

[62] See note 21 *supra;* Case, *Tax Consequences of the Family Partnership,* 8 Md. L. Rev. 171, 189 (1944); Elrod, *supra* note 7, at 74; Hellerstein, *The Tax Status of Family Partnerships,* 17 Rocky Mt. L. Rev. 197, 214 (1945).

[63] See Commissioner v. Tower, 327 U. S. 280 (1946); Barrett v. Commissioner, 185 F. 2d 150 (1st Cir. 1950); Fletcher v. Commissioner, 164 F. 2d 182 (2d Cir. 1947); Boylin v. Commissioner, 14 T. C. 542 (1950).

[64] Int. Rev. Bu. Mim. 6767 (February 19, 1952), 4 P-H 1952 Fed. Tax Serv. ¶ 76,179 (1952).

[65] *Ibid.;* see U. S. Code Cong. Serv., Sp. Rev. Pamph. 3089, 3129 (1951) (Senate Report); *id.* at 2935 (House Report); *cf.* Helvering v. Horst, 311 U. S. 112, 119 (1940); Helvering v. Clifford, 309 U. S. 331, 335 (1940); Zander v. Commissioner, 173 F. 2d 624 (5th Cir. 1949); Benson v. Commissioner, 161 F. 2d 821 (5th Cir. 1947); Hash v. Commissioner, 152 F. 2d 722 (4th Cir. 1945); Rose v. Commissioner, 65 F. 2d 616 (6th Cir. 1933); McCauley v. Commissioner, 44 F. 2d 919 (5th Cir. 1930); see Comment, 46 Ill. L. Rev. 636, 638 (1951).

[66] U. S. Code Cong. Serv., Sp. Rev. Pamph. 3089, 3129 (1951) (Senate Report); *id.* at 2935 (House Report); *accord,* Sinopoulo v. Jones, 154 F. 2d 648, 651 (10th Cir. 1946); *cf.* Helvering v. Clifford, 309 U. S. 331, 343 (1940) (dissenting opinion); see Elrod, *supra* note 7, at 69; Hellerstein, *supra* note 62. *But cf.* Whayne v. Glenn, 59 F. Supp. 517, 524 (W. D. Ky. 1945).

[67] *Ibid.*

whether such an arrangement were not a mere sham. But the mere retention of the power would not, ipso facto, seem enough to invalidate the partnership for tax purposes.[68] The test will be the ownership of the partnership interest, the use made of the control as trustee, and the disposition of the trust income.[69] Where it is found that the donor-trustee used his control chiefly to further his own plans, or employed the income to defray expenses normally borne by himself, the trust should be invalidated.[70]

Difficulties Remaining

If the definition of "family" in Section 191 is exclusive, then the presumption of gift would not seem to apply between brothers, or other collaterals, since these persons do not come within the definition. Under such an interpretation, there would be no reallocation of profits between brothers who purchased their interests.[71] This might seem to be a somewhat strained application of the statute, but it serves to introduce the problems left unsolved by the recent amendments.

Another problem arises in the question of definition: just what is meant by ". . . a partnership in which capital is a material income producing factor. . . ."?[72] Congress gave no indication of its meaning, but the idea has appeared before in cases involving personal service corporations. In these cases, the decision was not based upon the per cent of the total income that was produced by capital,[73] nor the amount of income thus derived,[74] nor the amount of capital so employed.[75] The issue was decided by finding whether capital, rather than services, produced the income.[76] Partnerships exist in which capital has been found to be essential in the production of the firm's income.[77] It has been suggested that the test might be ". . . whether the death of one or more of the partners would tend

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68 *Ibid.*

69 U. S. Code Cong. Serv., Sp. Rev. Pamph. 3089, 3129 (1951) (Senate Report); *id.* at 2935 (House Report); INT. REV. BU. Mim. 6767 (February 19, 1952), 4 P-H 1952 FED. TAX SERV. ¶76,179 (1952).

70 See note 61 *supra.*

71 See text following note 51 *supra.*

72 See text at note 1 *supra.*

73 Edward P. Allison Co. v. Commissioner, 63 F. 2d 553, 558 (8th Cir. 1933).

74 Crider Bros. Commission Co. v. Commissioner, 45 F. 2d 974 (8th Cir. 1931); *cf.* Matteson Co. v. Willcuts, 12 F. 2d 447, 450 (D. Minn. 1926).

75 6 B. T. A. 1225.

76 *Accord,* Franciscus Realty Co. v. Commissioner, 39 F. 2d 583 (8th Cir. 1930). *But cf.* Fuller & Smith v. Routzahn, 23 F. 2d 959 (N. D. Ohio 1927).

77 See Whayne v. Glenn, 59 F. Supp. 517 (W. D. Ky. 1945); Hardymon v. Glenn, 56 F. Supp. 269 (W. D. Ky. 1944); Thornton v. Commissioner, 5 T. C. 116 (1945); Note, 164 A. L. R. 1144, 1160 (1946).

substantially to end the income of the partnership."[78] If it did, then capital was probably not a material income-producing factor. The problem rests with the courts; yet a conclusion might be hazarded that if *any* income results from the use of capital, rather than from services, the partnership is within the meaning of Section 3797.[79]

A further difficulty arises from the statute's failure to define the term, "capital interest." It is probable that this phrase was intended to refer to a share in the partnership assets, that is, a right to share in the distribution of those assets upon the dissolution of the firm.[80]

The reallocation provision of Section 191 seems destined to cause dissension. It is not certain whether it is to be limited to cases of donated interests, or whether it may be applied even in instances where the interest was obtained other than by gift. The provision defining "family" may also cause litigation in cases of reallocation on income between brothers or other collaterals who purchase their interests.

Conclusion

Although the enactments may not do all that could be desired, it is believed that they have achieved certain beneficial results. The issues discussed in pre-amendment decisions[81] should now be reduced to the one question of the real, bona fide ownership of the interest under Section 3797.[82] In effect this would be a return to the early law which made ownership of the interest the controlling test. Therefore, under the recent statute, the inconsistency between the local property laws and the federal revenue laws appears to be resolved; the former determining the partnership interests, and the latter taxing them. In addition, the lesser amount of proof that should now

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[78] Packel, *supra* note 34, at 159.

[79] See INT. REV. BU. Mim. 6767 (February 19, 1952), 4 P-H 1952 FED. TAX SERV. ¶ 76,179 (1952) (The Bureau speaks of firms in which ". . . capital is not clearly unnecessary to the conduct of the business. . . .").

[80] *Accord,* Blodgett v. Silberman, 277 U. S. 1 (1928). The only interest a partner has in the firm's property is ". . . simply a right to share in what would remain of the partnership assets after its liabilities were satisfied . . . merely an interest in the surplus. . . ." *Id.* at 11. *Cf.* Shunk v. Commissioner, 173 F. 2d 747 (6th Cir. 1949); Jones v. Way, 78 Kan. 535, 97 Pac. 437 (1908); Riddell v. Ramsey, 31 Mont. 386, 78 Pac. 597 (1904).

[81] See note 38 *supra.* The Reports state that the courts, in applying the tests of intention, business purpose, reality and control, ". . . have in practical effect reached results which suggest that an intrafamily gift . . . where the donee performs no substantial services, will not usually be the basis of a valid partnership for tax purposes."

[82] But the tests suggested in the *Culbertson* case have been reaffirmed. If the ". . . usual characteristics of an arm's length transaction . . ." exist, the donee will probably be recognized as a partner, but the ". . . reality, good faith, and business purpose . . ." of the transaction will still be sought. See INT. REV. BU. Mim. 6767 (February 19, 1952), 4 P-H 1952 FED. TAX SERV. ¶ 76,179 (1952).

be required to establish a valid family partnership for tax purposes will facilitate the reduction of the family's income taxes.

The provision for insuring that the distributive shares of the partners in the family firm will be equitable, by permitting reallocation if they are not, is another legislative achievement. The problems remaining are not insurmountable, and should not bar successful enforcement of these amendments so as to bring some measure of harmony into the laws regarding the recognition of family partnerships in the federal tax courts.