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Recent Decisions

FEDERAL INCOME TAXATION—FAMILY PARTNERSHIPS

In 1939, because of his age and health, R. S. Coon decided to dissolve the long established cattle-raising partnership of Coon & Culbertson. Culbertson also was growing old, but he had four ranch-reared sons in whom Coon took an interest. Coon sold Culbertson his half interest in the partnership on condition that the latter re-sell that half interest to his sons so that the herd could be kept intact. The father was paid with the sons' note which was later satisfied in part from the profits of the business and in part by cancellations as a gift. One son acted as foreman, and the other three worked on the ranch when not in school. All members of the partnership could draw on the business checking account. When income from the ranch was reported on a partnership basis, the Commissioner of Internal Revenue assessed a deficiency against Culbertson. The Tax Court upheld the assessment, declaring the partnership invalid for tax purposes.[1] The Court of Appeals reversed, holding that there was a partnership.[2] The Supreme Court held that the Tax Court had applied erroneous tests. However, it reversed the appellate decision and remanded the case to the Tax Court since it was for that court, using the correct legal tests, to determine whether a partnership existed within the tax statutes.[3]

Prior to 1946 the courts drew this distinction in family partnership cases: One could not avoid tax liability by dividing income derived principally from his personal services with a member of his family whom he had designated a partner with him,[4] but he could lessen tax liability by designating a member of his family a partner with respect to income-producing property.[5]

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[1] W. O. Culbertson, Sr., P-H 1947 TC MEM. DEC. ¶ 47,168 (1947).

[2] Culbertson v. Commissioner, 168 F.2d 979 (C.C.A. 5th 1948).

[3] Commissioner v. Culbertson, 337 U. S. 733, 69 Sup. Ct. 1210 (1949).

[4] Burnet v. Leninger, 285 U. S. 136, 52 Sup. Ct. 345 (1932); Lucas v. Earl, 281 U. S. 111, 50 Sup. Ct. 241 (1930); Schroder v. Commissioner, 134 F.2d 346 (C.C.A. 5th 1943) (mechanical and electrical engineer); Mead v. Commissioner, 131 F.2d 323 (C.C.A. 5th 1942), *cert. denied,* 318 U. S. 777, 63 Sup. Ct. 851 (1943) (insurance and real estate business); Earp v. Jones, 131 F.2d 292 (C.C.A. 10th 1942), *cert. denied,* 318 U. S. 764, 63 Sup. Ct. 665 (1943) (insurance business). 47 MICH. L. REV. 595 (1949); 46 MICH. L. REV. 703 (1948).

[5] Blair v. Commissioner, 300 U. S. 5, 57 Sup. Ct. 330 (1937); M. W. Smith, Jr., 3 T.C. 894 (1944) (lumber mill); J. D. Johnston, Jr., 3 T.C. 799 (1944) (peanut

In 1946 the cases of *Commissioner v. Tower*[6] and *Lusthaus v. Commissioner*[7] changed the approach to the problem of taxing family partnerships. In the *Tower* case the husband was president of a corporation which made saw mill machinery. To reduce his taxes, he transferred stock to his wife on the condition that she reinvest the avails thereof in a limited partnership to be formed after liquidating the corporation. As planned, the corporation was liquidated and the partnership formed. The wife did not contribute services.[8] It was held that this was not a partnership under the tax statutes. In the *Lusthaus* case the husband owned a retail furniture business. To avoid taxes, he sold an undivided half interest in the business to his wife. He gave her a check which she returned along with notes for an additional sum of money to be paid out of her share of the profits. She contributed only incidental services. It was held that this was not a valid partnership for tax purposes.

These cases were a green light to Tax Court efforts to eliminate tax avoidance *via* family partnerships.[9] The Tax Court interpreted the two decisions as setting up the test that either vital services must be performed by the family member or capital originating with him must be contributed in order to create with another family member a partnership within Internal Revenue Code Sections 181 and 182. The principal case disapproves this interpretation as "at best, an error in emphasis."[10] The Court repeats what it said in the *Tower* case—that the question whether the family partnership is valid for income-tax purposes depends upon:

> whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both. And their intention in this

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butter manufacture and sale); 47 MICH. L. REV. 595 (1949); 46 MICH. L. REV. 703 (1948).

[6] 327 U. S. 280, 66 Sup. Ct. 532 (1946).

[7] 327 U. S. 293, 66 Sup. Ct. 539 (1946).

[8] Note that she could not have done so without incurring the liability of a general partner.

[9] T. Carrol Sizer, *Federal Income Tax Treatment of Family Partnerships Since the Tower and Lusthaus Cases*, (1947) WIS. L. REV. 293. Out of 78 cases litigated in the 13 months after the *Tower* and *Lusthaus* cases, only 14 family partnerships were upheld, 6 were partially upheld, and 58 were denied recognition for tax purposes.

[10] Commissioner v. Culbertson, 337 U. S. 733, 741, 69 Sup. Ct. 1210, 1213-14 (1949). As to the confusion resulting from the Tax Court's error in emphasis, see R. E. Mannheimer & H. T. Mook, *A Taxwise Evaluation of Family Partnerships*, 32 IOWA L. REV. 436, 451-55, 460 (1947).

> respect is a question of fact, to be determined from testimony disclosed by their agreement, considered as a whole, and by their conduct in execution of its provisions.[11]

"Original capital and vital services" are still to be considered in determining intent,[12] but the Tax Court is warned not to convert these guides into final tests.[13] Thus the law of the *Tower* case has not been changed, but the interpretation placed upon that law by the Tax Court has been corrected. Now the question is one of intention—the test a subjective one.

Although a family partnership may now be held valid where there is no contribution of "original capital or vital services," there still remains the problem of showing the required intention. Certainly the absence of a tax avoidance motive will continue to add strength to a claim of partnership.[14] It is also suggested that it will aid the taxpayer in establishing his partnership under the income tax laws if he is able to show that the partnership was formed because it was expected that the business would be benefited in some way by the addition of family members—even

[11] Commissioner v. Culbertson, 337 U. S. 733, 741-42, 69 Sup. Ct. 1210, 1214 (1949), quoting from Commissioner v. Tower, 327 U. S. 280, 287, 66 Sup. Ct. 532, 536 (1946).

[12] Commissioner v. Culbertson, 337 U. S. 733, 744, 69 Sup. Ct. 1210, 1215 (1949).

[13] *Id.* at 742-48, 69 Sup. Ct. at 1214-17. See Seabrook v. Commissioner, 176 F.2d 605 (C.C.A. 5th 1949) and Ginsburg v. Arnold, 176 F.2d 879 (C.C.A. 5th 1949). Both of these cases were decided after the *Culbertson* case, and in both the appellate court remanded the causes to the lower court for a new determination in accordance with the principles set forth in the *Culbertson* case. In the *Ginsburg* case the court of appeals at first rendered a judgment declaring that no partnership existed; seemingly the court overemphasized the factors of "original capital and vital services"; however, the court, on petition for rehearing, set its judgment aside and remanded the cause to the district court.

[14] Section 301 of the Revenue Act of 1948, Internal Revenue Code § 12, allowing a husband to "split" his income with his wife for tax purposes, will not only do away with the tax avoidance motive in husband-wife partnerships but will also completely remove this type of combination from attack by the Commissioner.

[15] Except for tax avoidance no benefit to the business was expected in the *Tower* case. There was a benefit in the *Lusthaus* case (increase of credit because the wife had property outside the business) but the partnership was not organized to procure this benefit. The Culbertson partnership was formed not to avoid taxes (at the time large profits were not expected) but to achieve a benefit by earmarking experienced and intelligent young men for the perpetuation of the business.

There is a public policy argument in favor of parent-child partnerships not available to husband-wife partnerships. Parent-child associations encourage the passing of the enterprise to succeeding generations. This is socially more desirable than to have business establishments die with their founders. 62 HARV. L. REV. 136, 138 (1948).