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FAMILY PARTNERSHIPS AND THE INCOME TAX—THE *CULBERTSON* CHAPTER

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Income tax legislation under the Sixteenth Amendment has followed the common law view of partnership to the extent of providing that a partnership shall not be a taxable entity like a corporation, but the individual partners shall be taxed on the partnership income in proportion to their distributive shares.[1] A great deal of water has gone over the tax dam since the dim and distant days of 1913 when this comparatively simple provision first found its way into the statutes. Two world wars have brought surtax rates to levels which certainly would have startled and possibly horrified even the more enthusiastic of the early advocates of the income tax. Faced with the demand of government for an ever greater take from their earnings, taxpayers have exercised their undoubted right of arranging their affairs so as to give maximum protection against the inroads of the tax gatherer. One of the standard blueprints for this purpose calls for the division of income among a number of recipients. The income is still subject to tax, but if the plan is successful the applicable surtax rates will be lower, frequently much lower. If the recipients are the persons who would use the income anyway, no financial sacrifice has been incurred, except by the government. Obviously a family group,

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1. INT. REV. CODE, § 181.

which derives its support from the property or services of a dominant income-producing member, furnishes a field with tax savings ripe for the plucking *provided* there is not a slip between the blueprint and the accomplishment. It is not surprising therefore that family partnerships have sprouted in recent years as never before, creating problems quite beyond the anticipation of the original draftsmen of the income tax statute.

So far as husband-wife partnerships are concerned, the problem has been eliminated for years after 1947 by the enactment of the split-income provisions of the Revenue Act of 1948.[2] Spouses may now generally divide their income between them without resort to partnership or other assignment devices. But the family partnership problem is still with us when other members of the family, such as children, are made partners.

Section 181 of the Internal Revenue Code, like revenue legislation of earlier years, provides that "individuals carrying on business in partnership shall be liable for income tax only in their individual capacity." This general declaration is supported by the statement in section 182 that "in computing the net income of each partner, he shall include, whether or not distribution is made to him," his "distributive share" of the ordinary net income and the capital gains and losses of the partnership.[3] There is no doubt as to the general effect of these provisions when a partnership is created by persons who contribute capital, services, or management skill to the business in proportions comparable to their fixed shares of the earnings. In this case each partner is to be taxed on his distributive share of the earnings as determined by the partnership agreement. Here taxability under the federal revenue law follows ownership of the income as determined by the applicable state law of partnership.[4] No doubt this was the type of situation which the draftsmen of the partnership sections of the tax law had in mind. But when a partnership is created merely as a device to divide income among members of a family group quite a different picture is presented. Frequently the new participants in the business contribute neither capital nor services to the enterprise and have no voice in management. The arrangement may be one which state law will enforce according to its terms and the courts of the jurisdiction where it is created may describe it as a "valid partner-

2. INT. REV. CODE, §§ 12 (d), 51 (b).

3. See also U. S. Treas. Reg. 111, §§ 29.182, 29.183 (1942). INT. REV. CODE, § 3797 (a) (2) provides: "The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term 'partner' includes a member in such a syndicate, group, pool, joint venture, or organization."

4. Blair v. Comm'r, 300 U. S. 5 (1937).

ship." [4a] Nevertheless it may be nothing more than a device whereby the producer of income distributes it among members of his family without essentially changing his economic position. The critical eye which the tax law casts upon such an arrangement is shown by a long line of decisions dealing with the tax effect of gratuitous assignments.[5]

Section 11 of the Internal Revenue Code imposes the tax "upon the net income of every individual." Section 22 (a) provides that such income shall include "income derived from salaries, wages . . . businesses, commerce, or sales or dealings in property, . . . interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever." By a progressively expanding interpretation, the courts have applied these very general statements broadly to achieve the objective of a tax designed to reach ability to pay. One of the best illustrations of this approach is found in the cases involving gratuitous assignments of income. The question they raise is whether the donor (usually in the higher tax brackets) or the donee (usually in the lower brackets) should be taxed for an item which is admittedly income to one or the other. The answer is not found merely by a determination of the rights of the parties under the state law involved. This can be illustrated by the case of a father who shortly before a salary, interest, or dividend payment is due makes an irrevocable assignment of it to his son.[6] There being no fraud on creditors, the assignment may be effective to transfer ownership to the son for all non-tax purposes. But for income tax purposes the father has not taken the item out of his income and placed it in his son's. In practical consequence the receipt is as much the father's income as if it had been deposited in his bank account and he had then drawn a check to his son. A taxpayer cannot avoid tax on income which he gives away when he retains all the important benefits of actual receipt.[7]

4a. "When the question is raised, in a legal controversy, whether or not two or more persons are 'partners,' the controversy usually concerns the liability of one of them for an obligation which he did not personally incur, *i. e.*, whether or not the facts of his relations to the others empowered them to obligate him. Indeed, a single controversy is inconceivable in which the existence or non-existence of *all* of the attributes of a partnership, as heretofore described, is in issue. Hence, whenever the question of 'partnership' is debated, the vital problem is not whether the associates are 'partners'—there are no useful tests by which all the answers to such a multiple question might be determined. The real problem always is whether the existing facts are those which the law recognizes as sufficient to produce the particular legal consequence in issue." FREY'S CASES AND STATUTES ON BUSINESS ASSOCIATIONS 81 (1935). See also note 70b, *infra*.

5. See, *e. g.*, Lucas v. Earl, 281 U. S. 111 (1930); Helvering v. Horst, 311 U. S. 112 (1940); Harrison v. Shaffner, 312 U. S. 579 (1941); Helvering v. Eubank, 311 U. S. 122 (1940); Whitehead v. Comm'r, 148 F. 2d 718 (4th Cir. 1945).

6. See Helvering v. Horst, *supra*, note 5.

7. *See* Mr. Justice Stone in Helvering v. Horst, 311 U. S. 112, 114 (1940).

The application of such a doctrine has many difficulties, for it is recognized that if a taxpayer completely and irrevocably gives away property he is not taxable on the income which accrues from the property after the date of the gift.[8] Obviously, a man is not to be taxed on income from property with which he has no connection simply because he once owned it and gave it away.[9] Four leading cases in the Supreme Court indicate the complexion of the decisions. In *Lucas v. Earl*[10] a husband had entered into an agreement with his wife, assumed to be valid under state law, by which all future earnings of the husband should be owned by the parties as joint tenants. It was held that the husband remained taxable on all his earnings, consisting of attorney's fees. Speaking for a unanimous court Justice Holmes said: "There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew."[11] By this decision and others which have followed, it has become clear that unless a partnership arrangement is an exception, there is no means by which a taxpayer may give away compensation for his services so as to avoid including that compensation in his income.[12] On the other side of the line is *Blair v. Commissioner*[13] where the taxpayer completely assigned to a daughter his life interest, which was his whole interest, in a trust. The court distinguished the *Earl* case and held that the father was not taxable on the trust income accruing after the assignment. It was thought that in this case the tax was upon income "as to which, in the general application of the revenue acts, the tax liability attaches to ownership."[14] In 1940, three years after its decision in the *Blair* case, the famous decision in *Helvering v. Clif-*

8. Austin v. Comm'r, 161 F. 2d 666 (6th Cir. 1947); Anthony v. Comm'r, 155 F. 2d 980 (10th Cir. 1946). But *cf.* Helvering v. Eubank, 311 U. S. 122 (1940), wherein the taxpayer, an insurance agent, made an absolute assignment of future renewal commissions on policies already written; but notwithstanding the fact that he completely divorced himself from any control over the future commissions he was held taxable on all future income received by assignee. The justification for such a result may be in order to establish a rigid rule forbidding the person, who by his personal services earns the income, from transferring the tax liability to the assignee.

9. See MERTENS, FEDERAL INCOME TAXATION, §§ 18.02, 18.14 (1942).

10. 281 U. S. 111 (1930).

11. *Id.* at 114.

12. See Helvering v. Eubank, 311 U. S. 122 (1940).

13. 300 U. S. 5 (1937). But *cf.* Harrison v. Shaffner, 312 U. S. 579 (1941).

14. Blair v. Comm'r, 300 U. S. 5, 12 (1937); *cf.* Poe v. Seaborn, 282 U. S. 101 (1930) (husband's earnings taxed according to ownership in community property states, *i. e.*, one-half to each spouse).

ford[15] indicated latent vitality in the general provisions of section 22 (a) as a limitation on tax avoidance.[16] Clifford had created an irrevocable trust for a term of five years in favor of his wife. Upon expiration of the term, the trust property was to revert to the grantor. He made himself trustee with powers over investment of the trust funds, including the power to vote the stock held in trust. A majority of the Court thought that the trust arrangement did not involve enough actual change in the husband's relation to the trust income to justify a shift in tax from him to his wife. "In this case," said Justice Douglas, "we cannot conclude as a matter of law that respondent ceased to be the owner of the corpus after the trust was created. Rather, the short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by respondent all led irresistably to the conclusion that respondent continued to be the owner for the purposes of section 22 (a)." [17] A few months later came the decision in *Helvering v. Horst*.[18] The owner of negotiable bonds had detached negotiable interest coupons shortly before their due date and delivered them as a gift to his son, who collected them at maturity during the same year. It was held that the interest was taxable to the father. Justice Stone attempted to summarize previous decisions, including those in the *Earl, Blair* and *Clifford* cases, by the statement: "Underlying the reasoning in these cases is the thought that income is 'realized' by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them." [19]

Thus came to fruition what has been called the *"Clifford-Horst* doctrine," [20] which extended the tax liability of assignors beyond the

15. 309 U. S. 331 (1940).

16. *Cf.* Helvering v. Wood, 309 U. S. 344, wherein the Treasury lost the argument that settlor's reversionary interest after short-term trust amounted to a "power to revest" within the meaning of INT. REV. CODE, § 166.

17. Helvering v. Clifford, 309 U. S. 333, 335 (1940). In 1945 the Treasury issued T. D. 5488, 1 C. B. 19 (1946), which added U. S. Treas. Reg. 111, §§ 29.22 (a)-21, 29.22 (a)-22, and 29.166-2. It was the purpose of this T. D. to describe the factors which will make trust income taxable to a person under the Clifford doctrine. See Guterman, *The New Clifford Regulations,* 1 TAX L. REV. 379 (1946); Pavenstedt, *The Treasury Legislates! The Distortion of the Clifford Rule,* 2 TAX L. REV. 7 (1946). In 1947, the Treasury issued T. D. 5567, which amended the *Clifford* regulations.

18. 311 U. S. 112 (1940).

19. *Id.* at 114.

20. See MAGILL, TAXABLE INCOME, 299-302 (1945).

limits which theretofore had been perceived. For several years the Board of Tax Appeals, which became the Tax Court in 1942, had from time to time dealt with the tax incidence of family partnerships. However, it now became plain that its prior decisions would have to be reappraised in light of the new pronouncements.[21] The importance of the reappraisal was heightened by the crop of family partnerships which soon began to sprout in the soil of World War II surtaxes. By 1944 there were unmistakable signs of struggle within the Tax Court.[22] The large number of family partnership cases decided during 1944 and 1945 presented factual situations too varied to be classified according to any system of doctrinal pigeon-holing. However, they did show certain important areas of agreement and disagreement. There seemed to be agreement that a partnership, recognized as such by the tax law, could be created within the family group.[23] The family might be an economic unit but it was not generally treated as a taxable unit by the Internal Revenue Code.[24] Consequently it was possible for a taxpayer to make his wife or his child a partner with him in a business so that each would be taxed on his distributive share of the earnings as provided by section 182. It also seemed to be generally agreed that the cases developing the so-called *Clifford-Horst* doctrine, referred to above, had important bearing on the existence of a partnership for tax purposes and that such a partnership would not be recognized solely because a valid partnership had been created under state partnership law.[25] Thus it was recognized that the economic source of the partnership income was a vital factor.[26] If the income was produced by the personal services of the husband or father, and the wife or child contributed no services, *Lucas v. Earl* [27] was held to be controlling and the income was all taxable to the husband or father, although the wife or child might have a legally enforceable partnership interest in the earnings under state law.[28] If the partnership income was produced

21. *See* Comm'r v. Sunnen, 333 U. S. 591, 603 (1948).

22. For a typical example of how the Tax Court split, see Lowry, 3 T. C. 730 (1944) (gifts of stock to wives in anticipation of dissolution of the corporation and the creation of the partnership held insufficient to make the wives partners for tax purposes).

23. For an analytical appraisal of the Tax Court decisions up to 1945, see Judge Mellott concurring in Thoirez, 5 T. C. 60, 69 (1945).

24. See Bruton, *The Taxation of Family Income*, 41 YALE L. J. 1172 (1932).

25. *See* Comm'r v. Tower, 327 U. S. 280, 287 (1946) (Tax Court in making a final authoritative finding on the question whether this was a real partnership is not governed by how Michigan law might treat the same circumstances for purposes of state law). A "partnership" may be created under state law by gift of an interest, see note 70b, *infra*.

26. See, *e. g.*, Lowry, 3 T. C. 730 (1944); Thoirez, 5 T. C. 60 (1945); Berson, 6 T. C. 748 (1946); Durwood, 6 T. C. 682 (1946); Akers, 6 T. C. 693 (1946).

27. See note 10, *supra*.

28. *E. g.*, Mead v. Comm'r, 131 F. 2d 323 (1943); Schroder v. Comm'r, 134 F. 2d 346 (1943); Earp v. Jones, 131 F. 2d 292 (1943); Tirkoff v. Comm'r, 120 F. 2d 564 (1941).

in substantial degree by capital as well as services, the more usual case, conflicting views arose.[29] In the typical situation the business was created and carried on by capital and services supplied by the husband or father who under the partnership agreement retained control of the business. The wife or child supplied little or no services, did not participate in management, and acquired a capital interest only by gift from the husband or father. This gift was accomplished either by an outright assignment of a partnership interest or by a gift of capital which was almost immediately thereafter contributed to the partnership. The opinions of the Court as to how this situation should be treated developed a recognizable cleavage in viewpoint. One segment of the Court adopted the government's position to the effect that this was essentially a *Clifford-Horst* situation in which the owner of a business purported to give away an interest in that business but retained so much control that he should continue to be taxed on the income.[30] The other view, more favorable to the taxpayer, took the approach that the decision was governed by the doctrine of the *Blair* case; that property in the form of an interest in business had been given away so completely that the income therefrom should thereafter be taxed to the donee and not the donor.[31] It should be noted that by neither view was the creation of a valid partnership under state law the controlling consideration. The government's position won ascendancy within the Court.[32] In so far as this could be stated as a rule it was that tax recognition would be withheld from a family partnership when the putative partner did not participate in management and contributed neither "vital services" nor capital other than that which he received by gift from the controlling partner.

The situation obviously called for a decision by the Supreme Court and that tribunal undertook to deal with it in the *Tower* and *Lusthaus* cases decided in 1946.[33] The essential facts of the *Tower* case were as follows: In 1927 Mr. Tower had inherited a manufacturing business located in Michigan. In 1933 the business was incorporated, Tower acquiring 445 of the 500 outstanding shares and his wife receiving 5 shares. In 1937 substantial profits pointed to increased taxes and

29. For a vivid illustration of the diversity of opinions of the judges of the Tax Court, see Thoirez, 5 T. C. 60 (1945), wherein there are two concurring opinions and three dissenting opinions.

30. The leading exponents of this view were Judges Harron and Opper. See Judge Harron dissenting with Opper in Johnston, 3 T. C. 799, 810 (1944); Zukartes, 3 T. C. 814, 819 (1944), Smith, 3 T. C. 894, 908 (1944), Scherer, 3 T. C. 776, 908 (1944).

31. Judge Black was the most forceful backer of this position. See Scherer, 3 T. C. 776 (1944).

32. See, *e. g.*, Schreiber, 6 T. C. 707 (1946); Benson, 6 T. C. 748 (1946); Durwood, 6 T. C. 682 (1946); Akers, 6 T. C. 693 (1946).

33. Comm'r v. Tower, 327 U. S. 280 (1946); Lusthaus v. Comm'r, 327 U. S. 293 (1946).

Tower's attorney and accountant advised him that a partnership with his wife would result in tax savings and eliminate the necessity of filing corporate returns. Following this advice, Tower gave his wife 190 shares of the company's stock upon condition that she place the corporate assets represented by these shares in a new partnership. He paid a gift tax on the gift of the shares, which were valued at $57,000. Three days after the gift the corporation was dissolved, a limited partnership was formed and a certificate of partnership duly filed as required by Michigan law. On the books of the partnership the value of the donated stock became the wife's contribution to the partnership. As a limited partner she had no voice in management and shared profits and losses in the ratio of 39% as compared with her husband's 51%. Mr. Tower continued to have the controlling voice in the business. The Commissioner ruled that the wife's share of the partnership profits for 1940 and 1941, which she received and used for general personal and family purposes, had actually been earned by her husband and consequently were taxable to him.

The Tax Court sustained the Commissioner in an opinion by Judge Harron which was not reviewed by the full court.[34] Referring to the understanding that the stock would be surrendered upon creation of the partnership, she said: "A careful analysis of the testimony of this proceeding leads us to the conclusion that petitioner did not make a valid gift of the corporate stock to his wife in that he did not absolutely and irrevocably divest himself of the title, dominion, and control of the subject of the gift.[35] . . . In view of the fact that the gift of the corporate stock by petitioner to his wife was not valid and complete, it follows that she made no capital contribution to the partnership, and, since she admittedly rendered no services, it must be held that she was not a bona fide partner." [36] This conclusion was buttressed with the assertion that the partnership arrangement was a mere reallocation of the husband's business income within the family group with no business purpose other than the reduction of his income tax.[37]

After a reversal by the Circuit Court the case came on for decision in the Supreme Court,[38] where the ruling of the Tax Court was sustained. Justice Black, speaking for five members of the Court, stated the basic question squarely by saying: "Was the income attributed to the wife as a partner income from a partnership for which she alone was liable in her 'individual capacity,' as provided by sections 181 and 182 of the Internal Revenue Code, or did the husband, despite the

34. 3 T. C. 396 (1944).
35. *Id.* at 402.
36. *Id.* at 404.
37. *Id.* at 404-405.
38. 148 F. 2d 388 (1945).

claimed partnership, actually create the right to receive and enjoy the benefit of the income, so as to make it taxable to him under sections 11 and 22 (a)" as interpreted in the *Horst* case?[39]

After reciting the facts substantially as given above, Justice Black proceeded to put the Tax Court's ruling in the following setting:

> We are of the opinion that the foregoing facts were sufficient to support the Tax Court's finding that the wife was not a partner in the business. A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses. When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises 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 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." *Drennen v. London Assurance Co.,* 113 U. S. 51, 56; *Cox v. Hickman,* 8 H. L. Cas. 268. We see no reason why this general rule should not apply in tax cases where the Government challenges the existence of a partnership for tax purposes. Here the Tax Court, acting pursuant to its authority in connection with the enforcement of federal laws, has found from testimony before it that respondent and his wife did not intend to carry on business as a partnership. This finding of fact, since supported by evidence, is final. *Commissioner v. Heininger,* 320 U. S. 467, 475; *Dobson v. Commissioner,* 320 U. S. 489. The decision of the Tax Court was therefore correct unless, as respondent contends, the Tax Court erroneously disregarded or improperly applied certain legal principles.[40]

This paragraph is quoted in full because of the significance attached to it by the Court in the recent *Culbertson* case.[41]

There followed in the opinion an explanation of why the Tax Court did not erroneously disregard or improperly apply any legal principles. The points made may be summarized as follows: (1) In making its determination the Tax Court properly looked to tests found in the federal tax law and was not bound by the valid creation of a partnership under state law. After reference to the *Earl* and *Clifford* cases it is stated: "The statutes of Congress designed to tax income actually earned because of the capital and efforts of each individual member of a joint enterprise are not to be frustrated by state laws which for state purposes prescribe the relations of the members to each other

39. 327 U. S. 280, 283 (1946).
40. *Id.* at 286-287.
41. Comm'r v. Culbertson, 69 Sup. Ct. 1210 (1949).

and to outsiders." [42] (2) The Tax Court's holding did no violence to the principle that a taxpayer may reduce his tax by a lawful arrangement entered into for that purpose. The question is whether or not the taxpayer has by the arrangement in question sufficiently divorced himself from the income to achieve his purpose. The showing that a partnership was made for the express purpose of reducing taxes simply lends further support to the inference that the husband in this case still controls the income and that the earnings are really his.[43] (3) A wife may become a partner with her husband for tax purposes, but in determining whether she has or not the Tax Court may take into consideration the circumstances that she has contributed no capital or vital services and does not share in management.[44] (4) The Tax Court was justified in finding that the partnership brought about no real change in the economic relation of the husband to the income taxed, which is the chief concern of the tax law.[45] (5) The Tax Court's findings were supported by a sufficient number of other factors in the transaction, so that it is unnecessary to decide whether its holding as to the completeness of the gift of stock was correct.[46] "The issue is who earned the income and that issue depends on whether this husband and wife really intended to carry on business as a partnership." [47]

Justice Black concluded his opinion by saying:

> There was, thus, more than ample evidence to support the Tax Court's finding that no genuine union for partnership business purpose was ever intended and that the husband earned the income. Whether the evidence would have supported a different finding by the Tax Court is a question not here presented.[48]

It was apparently this last statement which caused Justice Rutledge to write a brief concurring opinion.[49] In his judgment the effect of the decision was "to rule that in situations of this character the formation of a limited partnership under state law between husband and wife, with the latter as the limited partner, following immediately upon the husband's donation to the wife of a share in the assets of the business previously and afterwards conducted by him and conditioned upon her leaving the assets in the business, does not as a matter of federal tax law accomplish the formation of a partnership sufficient to relieve the husband of tax liability for the income derived after the

42. 327 U. S. 280, 287-288 (1946).
43. *Id.* at 288-289. See Gregory v. Helvering, 293 U. S. 465, 469 (1934).
44. 327 U. S. 280, 290 (1946).
45. *Id.* at 291.
46. *Id.* at 290.
47. *Id.* at 287.
48. *Id.* at 292.
49. *Id.* at 292-293.

transfer from use in the business of the share thus donated to the wife." Justice Rutledge thought "that as a matter of law the taxpayers in these cases were liable for the taxes assessed against them" and the "Tax Court is not free in these or similar circumstances to draw either the contrary conclusion or opposing ones."[50] Apparently the disagreement between Justice Rutledge and the other five Justices in the majority was not over whether the Tax Court might properly adopt the rule as he stated it, but whether that Court was *compelled* to do so as a matter of law.

The Black and Rutledge opinions seemed to indicate that at least six members of the Court would not reverse the Tax Court if it chose to sustain what has been described above as the government's position in the family partnership cases. Such a reading of the opinions is strengthened by the character of the dissent by Justice Reed, which was concurred in by Chief Justice Stone.[51] The dissent expressed substantially the view which had been urged by minority members of the Tax Court in other cases. That view was that Tower had made a completed gift of an interest in the business; consequently the wife's share of partnership earnings represented income from property of which she had become the owner; and that she rather than her husband should be taxed for that income on analogy to the *Blair* case.

The *Lusthaus* case,[52] decided as a companion case to *Tower,* presented a substantially similar state of facts with regard to a husband-wife partnership created in Pennsylvania. Justice Black, again speaking for the same majority members of the Court, sustained the Tax Court in holding that no partnership had been created for tax purposes. He relied on the reasons given in his *Tower* opinion. The concurring and dissenting opinions were written to cover this case as well as *Tower.*

The *Tower* and *Lusthaus* decisions were generally read as supporting those Judges of the Tax Court who would make the tax status of a disputed member of a family partnership turn primarily on whether or not that member performed "vital services" or contributed capital originating with her or him.[53] Many subsequent Tax Court and Circuit Court decisions certainly followed such a reading.[54] That this was

50. *Id.* at 293.

51. *See* Mr. Justice Reed dissenting in Lusthaus v. Comm'r, 327 U. S. 293, 297 (1946).

52. See note 33 *supra.*

53. See note 30 *supra.*

54. See, *e. g.,* Moore v. Comm'r, 170 F. 2d 191 (1948); Hitchcock, 12 T. C. 22 (1949); Ritter, 11 T. C. 234 (1948); Denison, 11 T. C. 686 (1948); Morrison, 11 T. C. 696 (1948); Harris, 10 T. C. 818 (1948); Durwood, 6 T. C. 682 (1946).

error seems to be the effect of the pronouncement handed down in the recent *Culbertson* case.[55]

The facts of the case were that Culbertson from 1915 until 1939 had operated a cattle business in partnership with a man named Coon. Coon, who was 79 years of age, desired to dissolve the partnership because of ill health. However, he was interested in seeing the foundation herd of Coon and Culbertson maintained. He was also interested in Culbertson's four sons who wanted to enter the cattle business. It appears that these interests were genuine and not feigned. Consequently it was proposed that a new partnership should be formed, Culbertson & Sons, in which the sons should have an undivided one-half interest. This was accomplished by a sale of the assets to Culbertson who in turn sold a half interest to his sons. The father financed the first sale. The second was paid for by a gift of $21,000 from the father to the sons and a note for $30,000 procured by Culbertson & Sons. This note was repaid from proceeds of the business. It appears that the tax consequences of the partnership were not considered or discussed. The new partnership began operation in 1940 and the tax question arose for that year and the following one. At the time of the formation of the partnership the sons were 24, 22, 18 and 16 years old respectively. The oldest son was a college graduate and, until he went into the army, was foreman under the new partnership as he had been for two years under the old. The second son finished college in 1940 and went directly into the army without rendering any services to the partnership. The two younger sons went to school during the winter and worked on the ranch during the summer. The Tax Court disallowed the partnership division of income and based its decision on the finding that none of the sons had satisfied the requirement that each partner contribute vital services or capital originating with him.[56] The Circuit Court reversed on the ground that there was a good faith understanding that the sons would contribute vital services in the future.[57] Such an understanding was thought to distinguish the case from *Tower* and *Lusthaus*. A majority of the Supreme Court reversed the Circuit Court with directions to remand the case to the Tax Court.

Chief Justice Vinson, who delivered the opinion of the Court, attempted to explain why the Circuit Court had been wrong, but at the same time why the Tax Court had not been right in its interpretation of the *Tower* case. The evidence in the *Tower* case, he said, fully justified the "holding that the husband, through his ownership of the capital and his management of the business, actually created the right

55. See note 41 *supra*.
56. 1947 P-H TC MEM. DEC. SERV. ¶ 47,168 (1947).
57. 168 F. 2d 979 (1948).

to receive and enjoy the benefit of the income and was thus taxable upon that entire income under sections 11 and 22 (a). In such a case, other members of the partnership cannot be considered 'individuals carrying on business in partnership' and thus 'liable for income tax * * * in their individual capacity' within the meaning of section 181." [58] Thus as a matter of semantics, the Chief Justice brought the *Tower* reading of the partnership sections in line with the *Clifford-Horst* reading of sections 11 and 22 (a). Since the partnership sections are geared to the sections relating to taxation of individual income, he concluded:

> The intent to provide money, goods, labor, or skill sometime in the future cannot meet the demands of sections 11 and 22 (a) of the Code that he who presently earns the income through his own labor and skill and the utilization of his own capital be taxed therefore. The vagaries of human experience preclude reliance upon even good faith intent as to future conduct as a basis for the present taxation of income.[59]

Hence the Circuit Court had been wrong.

Having expounded the doctrine that the economic source of the income is the crucial question and having explained that the good faith intent to supply capital or services in future years cannot qualify under this doctrine, the Chief Justice then proceeds to take the view that the Tax Court misinterpreted the *Tower* decision by placing too much emphasis on the concepts of "vital services" and "original capital." [60] In doing this he relies upon a portion of Justice Black's statement in the *Tower* opinion which is quoted above.[61] This, he says, means that "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 parties in good faith and acting for a business purpose intended to join together in the present conduct of the enterprise." This "test," we are told, involves no more difficulty "than is ordinarily true of inquiries into the subjective." [62]

One may grant this and still be thoroughly unhappy with his task. But inquiries into subjective intent, difficult at best, become meaningless when one does not know the consequences for which he is seeking

58. 69 Sup. Ct. 1210, 1213 (1949).

59. *Id.* at 1213.

60. *Id.* at 1215. In support of the instant case, see Olson & Martin, *The Culbertson Case,* 27 TAXES 777 (1949).

61. See text at note 40 *supra.*

62. 69 Sup. Ct. 1210, 1214-1215 (1949). See Manheimer & Mook, *A Taxwise Evaluation of Family Partnerships,* 32 IOWA L. REV. 436 (1948).

an intent. What are the significant consequences in a family partnership situation? When, in the sense intended, do parties, acting with a "business purpose," join together "in the present conduct of the enterprise." The Tax Court thought they did not when one of the parties neither participated in management, contributed capital, nor supplied services. In such a situation the only possible consequence of the intent of the parties seems to be a sharing of income under an arrangement which state law may for its own purposes label partnership. If intent to create such an arrangement 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.

The Chief Justice also asserts that "the Tax Court's isolation of 'original capital' as an essential of membership in a family partnership indicates an erroneous reading of the Tower opinion. We did not say that the donee of an intra-family gift could never become a partner through investment of the capital in the family partnership." [63] This is quite true, but the Tax Court has never so held.[64] If an outright and complete gift of capital is made with no plan or expectation that it is to be used to create a partnership with the donor, and the donee sometime later decides of his own volition that he wishes to invest this property in such a partnership, an utterly different situation is presented than was before the Court in *Tower*.[65] It is also not the situation of the *Culbertson* case, or any other of the cases in which the Tax Court purported to apply its so-called test of vital services or original capital.

The opinion concludes:

> The cause must therefore be remanded to the Tax Court for a decision as to which, if any, of respondent's sons were partners with him in the operation of the ranch during 1940 and 1941. As to which of them, in other words, was there a bona fide intent that they be partners in the conduct of the cattle business, either because of services to be performed during those years, or because of contributions of capital of which they were the true owners, as we have defined that term in the Clifford, Horst and Tower Cases?

Surely this was more than an invitation to the Tax Court to make the same essential finding it had already made, but merely in the words

63. 69 Sup. Ct. 1210, 1216-1217 (1949).

64. See, *e. g.*, Anderson, 6 T. C. 956 (1946); Marks, 6 T. C. 659 (1946); Lawton, 6 T. C. 1093 (1946); Parker, 6 T. C. 974 (1946).

65. *Cf.* Anderson, 6 T. C. 956 (1946).

"no bona fide intent to be partners in the cattle business." [66] Is it a suggestion that the services performed by some of the sons during the years in question were sufficient to make them partners tax-wise? If so, it could certainly have been stated far more directly. How, on the record, which the taxpayer carries the burden of making, could the Tax Court find that any of the sons had contributed capital of which they were the owners within the meaning of the *Clifford, Horst,* and *Tower* cases?

The mysterious implications of the leading opinion are not clarified by the other opinions. Justices Black and Rutledge, the authors of the opinions sustaining the Tax Court in the *Tower* case, stated their belief "that the Tax Court properly applied the principles of the *Tower* and *Lusthaus* decisions." [67] But they acquiesced in the Court's opinion and judgment because they considered it "of paramount importance in this case to have a court interpretation of the applicable taxing statute for guidance in its application." Why, if they thought the principles of the *Tower* and *Lusthaus* cases had been correctly applied, they should acquiesce in an opinion which stated that those decisions had been misinterpreted, is difficult to perceive.

Justice Jackson, who did not participate in the *Tower* and *Lusthaus* decisions, stated that he would affirm on the opinion of the Circuit Court, "being of the view that the ordinary common-law tests of validity of partnerships are the tests for tax purposes and they were met in this case." [68] This seems to be essentially the view expressed more fully by Justice Frankfurter who said it seemed to him important "to make crystal clear that there is no special concept of 'partnership' for tax purposes." [69] Apparently he would not gear the partnership sections to sections 11 and 22 (a), thus incorporating the *Clifford-Horst* doctrine. It is his belief that "sections 181 and 182 import a concept of a different sort. These sections make taxability turn on the existence of the relation of 'partnership.' [70] The term carries its own meaning, just as does 'negligence' in the Federal Employers' Liability Act, because such a common-law concept has a content familiar throughout the country to those to whom the law speaks." [70a] It would seem that according to Justices Frankfurter and Jackson contribution of "original capital" or "vital services" would be relevant factors in determining the existence of a partnership for tax purpose only if they

66. 69 Sup. Ct. 1210, 1217 (1949).

67. *Id.* at 1217.

68. *Id.* at 1218.

69. *Id.* at 1218-1220.

70. The term partnership is merely defined in very general manner in INT. REV. CODE § 3797 (a). See note 3 *supra.*

70a. *Cf.* FREY, quoted note 4a *supra.*

were considered such generally by state law in determining the existence of partnership for its purposes.[70b]

It is too early to determine what the impact of the *Culbertson* case will be, or even if it will have any significant effect on the disposition of family partnership cases. No doubt the Tax Court will be more careful to make an express finding one way or the other on whether or not "the parties in good faith and acting for a business purpose intended to join together in the present conduct of the enterprise." As to what significant circumstances will influence this finding, one can only make unguided guesses. Perhaps participation in management, rendering of services and contribution of capital will continue to play about the same roles they have in the past. Two recent decisions of the Tax Court seem to indicate as much, but they were not rendered without vigorous dissent.[71]

The decision in *W. F. Harmon* was promulgated September 27, 1949.[72] Harmon and Kuhlmann had been engaged as partners in the machine tool business for several years prior to 1942. In that year they entered into a new partnership agreement purporting to make their wives and their two sons partners. Young Kuhlmann was aged twenty-three, and young Harmon, sixteen. Each partner was given a one-sixth interest in the business, and management was vested in the two fathers. It was provided, however, that in the event of death or incapacity of either father, voice in management should pass to his son. This provision came into effect when the elder Kuhlmann died in February, 1944, but the Kuhlmanns sold out to outside parties and retired from the business December 31, 1944. Young Harmon was incapacitated by an operation in September, 1943, and later that year was inducted into military service. Prior to his illness, he performed services in the shop, but his mother performed no substantial services. The capital contributions of Mrs. Harmon and her son were received by way of gifts from Mr. Harmon. A majority of the Tax Court held that for the years 1943 and 1944 there was no partnership for tax purposes with the wife, but there was with young Harmon. Expressly

70b. See MECHEM, ELEMENTS OF THE LAW OF PARTNERSHIP 4 (2d ed., 1920), where it is stated: "Though usual and often said to be essential, it seems not to be indispensable that *every* partner shall make a contribution." To this is appended the following footnote: "Thus it is said by Jessel, M. R., in Pooley v. Driver (1876), 5 Ch. Div. 458, Ames' Cas. 87, 'you can have, undoubtedly, according to English law, a dormant partner who puts nothing in,—neither capital, nor skill, nor anything else. In fact, those who are familiar with partnerships know it is by no means uncommon to give a share to the widow or relative of some former partner, who contributes nothing at all,—neither name, nor skill, nor anything else. Therefore it is not quite accurate, as Chancellor Kent puts it, that they must contribute labor, skill or money, or some or all of them.'"

71. W. F. Harmon, CCH 1949 FED. TAX REP. ¶ 17,196 (TC 1949); Edward A. Theurkauf, CCH 1949 FED. TAX REP. ¶ 17,226 (TC 1949).

72. W. F. Harmon, *supra* note 71.

acknowledging that the language was taken from the *Culbertson* opinion, the Court found the requisite intent to join together in the "present conduct of the enterprise" so far as the son was concerned, but not as to the wife.[73]

The decision denying the wife the status of a partner seems to lay practically as much stress upon the contribution of capital or services as did the *Tower* case. This provoked a dissent to the effect that if Mrs. Harmon was not a partner for tax purposes, the dissenters failed to understand the meaning of the *Culbertson* decision.[74] The case shows the difficulty of determining whether or not the *Culbertson* test of intent is to be given more than lip service and, if so, in what manner.

The ruling as to the inclusion of young Harmon in the partnership displays, perhaps, a more liberal attitude toward the recognition of minor children as partners. Possibly the court is now more willing to recognize a minor child as a partner if he participates in the business to some extent, and there is an evident intention that in the future he will fully work into the business. However, it is difficult to see how this can go very far without rejecting Chief Justice Vinson's view of the unimportance of an intention to perform services in future years.[75]

At the time of this writing, the most recent decision of the Tax Court is that promulgated October 7, 1949, in the case of *Edward A. Theurkauf*.[76] The taxpayer formed a partnership with his wife to carry on a business which theretofore had been operated by a corporation. Following the familiar pattern, the husband, on October 9, 1936, made a gift to his wife of stock in the corporation. This gift was made after he had decided to change the business from corporate form to that of partnership. The partnership was formed on October 31, 1936, when the corporation was liquidated and the wife surrendered her stock as her capital contribution to the partnership. She contributed no services and did not participate in management. The court found as a fact that the husband's gift of stock to his wife was made "with intent to vest full, complete and irrevocable legal ownership of said stock in the said Frances G. Theurkauf," and that "she thereupon became the owner of the shares covered by the certificate issued to her and no conditions or limitations were attached to her ownership of them."[77] Relying upon this finding, a majority of the court held that the wife had contributed capital under circumstances which made the *Tower* case distinguishable and she was a partner for tax purposes. Reliance was placed on the *Culbertson* decision.

73. *Id.* at 3427-3428.
74. *Id.* at 3429-3430. Judge Black dissenting with Judge Van Fossan.
75. Comm'r v. Culberston, 69 Sup. Ct. 1210, 1212-1213 (1949).
76. Edward A. Theurkauf, *supra* note 71.
77. *Id.* at 3524.

Six dissenters thought the holding was "contrary to the essential concepts of the Supreme Court on the subject." [78] They stressed several points of difference with the majority. The wife's contribution of capital was questioned in view of the fact that, prior to making the gift of stock, the husband had decided to form a partnership, which was consummated only three weeks after the gift. In view of these facts, it is hard to believe that it was expected or contemplated that the wife was to do anything with the stock except turn it in upon formation of the partnership. To stress her legal power to do otherwise seems to emphasize form at the expense of substance. It will be recalled that in the *Tower* case the Supreme Court thought it irrelevant whether Tower's gift of stock to his wife was legally complete or not.[79]

The dissent is also on strong ground when it points out that capital was apparently a minor factor in the production of the partnership income. This was evidenced by the fact that the business was one of "commission merchant, selling agent, and factor" and by the further fact that the capital paid in by both husband and wife amounted to only $29,700, as compared with $21,600 partnership income for 1944, which the Commissioner assessed against the husband. If a substantial part of the partnership income was attributable to the personal skill and services of the husband in a business which he managed, did not the *Earl* case require that at least that portion of the earnings be taxed to him, even though he bestowed them on his wife by means of a partnership? This would raise the difficult question of the allocation of partnership income between capital and services, which the Supreme Court expressly refused to pass upon in the *Culbertson* case.[80]

There is still crying need for a further clarification of the family partnership situation under the Internal Revenue Code. Of course, no general rules created by statute, administration regulation, or court decision can solve in advance many of the problems which must always turn on careful appraisal of a multitude of more or less unique factual situations. However, there are certain starting points which can and should be fixed. The most appropriate means would seem to be administrative action in the form of regulations, similar to those which have so helpfully clarified the trust problems which followed in the wake of the *Clifford* decision.[81] This is not a new suggestion, but it is worth renewing.

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78. Disney, J., dissenting with Murdock, Turner, Arnold, Hill, and Harron, JJ. *Id.* at 3526.

79. See text at note 46 *supra.*

80. Comm'r v. Culberston, 69 Sup. Ct. 1210, 1217 (1949); See Robinson, *The Allocation Theory in Family Partnership Cases,* 25 TAXES 963 (1947).

81. See note 17 *supra.*

It should be made absolutely clear that the Internal Revenue Code contains its own concept of what is a partnership for tax purposes. When partnership is resorted to as a means of allocating income to a member of the family group who makes no significant contribution toward the production of that income, the concept of a tax partnership should find its content largely in the *Clifford-Horst* line of cases. The *Clifford* decision itself brought within the broad sweep of section 22 (a) the problem of taxing trust income to the grantor of the trust. It did this even though sections 166 and 167 of the Code dealt specifically with the grantor's tax liability and in certain situations defined it more narrowly than the Court held it should be defined under section 22 (a). The partnership sections of the Code deal even less specifically with partnerships as gratuitous assignment devices, than do sections 166 and 167 in the case of trusts. Consequently, the partnership provisions, even less than those sections, should not foreclose a broad and realistic approach under section 22 (a). As a part of this point, it should be made plain that a partnership will not be effective tax-wise as an assignment device merely because it is a "valid partnership" for all purposes of concern to state law. This statement is made with all due deference to some things which are said in the *Culbertson* opinions.

An intent on the part of the parties to join together in the present conduct of the enterprise should not be stated as an independent or even primary criterion of a partnership for tax purposes. Intent has meaning only in light of the significance of the things intended. One is led immediately to an objective consideration of what was done, and in this situation tax liability should depend upon such objective result. Whether or not the parties have "joined together in the present conduct of the enterprise" must be determined in light of the principles developed in the *Clifford-Horst* line of cases, if those cases are to furnish the approach to the problem, as seems almost generally conceded.

If it is possible to state in one sentence the dominating thought of the whole series of cases dealing with gratuitous assignments, it is that a man should be taxed for that income which he controls and which is produced by his skill, service or capital. As applied to the family partnership cases, this must result in great weight being placed on a determination of the extent to which the disputed partner shares in management, performs services or really contributes capital which may constitute the source of the income which has been allocated to him. In the future it is to be expected that the emphasis will shift from husband-wife to father-child arrangements. Lines will probably be drawn to determine when the minor or neophyte, actually working in the business, has reached sufficient maturity in the enterprise to justify the

tax status of a partner, because of the skill and services which he is supplying, or because of the powers of management which he has assumed. We may expect that the courts, and even the Treasury, will view such putative partners with a friendlier eye than the wives in earlier cases, who merely drew out the income and bought new furnishings for the living room.