TAXATION

TAXATION OF THE FAMILY PARTNERSHIP

Among constitutional provisions controlling governmental taxation in United States is the prohibition, grounded in due process, against taxation to A of the income or the property of B. In the field of income taxation, the significance of this limitation flows from the struggle between the taxpayer and the government which is precipitated by the existence of highly progressive rates. Events increasingly attest the fact that constitutional protection is not easily invoked by the taxpayer who seeks to avoid the higher rate brackets through the device of "spreading" his income. On the other hand, that the protection of due process is not an empty thing is clear from *Hoeper* v. *Wis. Tax Comm.*, 284 U. S. 206, 52 Sup. Ct. 120 (1931), holding invalid a tax to the husband of his wife's income.

Supposedly astute draftsmen early conceived the idea that by the use of a revocable trust, the taxpayer's aims could be ideally realized within the aegis of the Constitution. The trust device was readily adaptable to "spreading," while the reservation of a power of revocation would retain to the settlor the desired control; yet the scheme would be beyond the reach of the government since all title to the income-producing property would be vested in parties other than the settlor. Surrey, "Assignments of Income and Related Devices: Choice of the Taxable Person", 33 Col. L.R. 791 (1933). The Treasury Department, by reversing its former position, forced Congress in 1924 to enact specific legislation in an attempt to nullify this avoidance device. Revenue Act of 1924, Sec. 219 (g). The constitutionality of this section was sustained in *Corliss* v. *Bowers*, 281 U. S. 376, 50 Sup. Ct. 336 (1930); the court saying "* * * taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." While such judicial attitude left little of value in the revocable trust device, draftsmen refused to disavow their faith in it. As a consequence, the matter settled down to a hide and seek contest between counsel and government. Although congressional legislation of 1932 and 1934, designed to close the loopholes discovered by ingenious counsel, has not been tested for its constitutionality, validity seems assured by *DuPont* v. *Comm.*, 289 U. S. 685, 53 Sup. Ct. 766 (1933); and *Helvering* v. *Farmers' Trust Co.*, 296 U. S. 85, 56 Sup. Ct. 70 (1935); respectively. See 22 Iowa L. Rev. 390, 392; Magill, Taxable Income, pp. 280-288 (1936).

If, however, these developments were casting increasing doubt upon the efficacy of the revocable trust, draftsmen were satisfied that sure relief could be had through the use of irrevocable trusts. But to their great amazement *Burnet* v. *Wells*, 289 U.S. 670, 53 Sup. Ct. 761 (1933), decreed the non-immunity of even this device in a theateningly broad category of situations. Had the decision been limited to situations where the trust income was directed to the payment of the settlor's legal obligations, it would have been significant enough. For under the influence of this reasoning, there has been taxed to the settlor the income from an alimony trust incorporated in the decree of divorce, *Douglas* v. *Willcuts*, 296 U.S. 1, 56 Sup. Ct. 59 (1935); income from trusts created for the support and maintenance of the settlor's children, *Helvering* v. *Stokes*, 296 U.S. 551, 56 Sup. Ct. 308 (1935); *Helvering* v. *Schweitzer*, 296 U.S. 551, 56 Sup. Ct. 304 (1935); and income of a trust directed to the payment of the principal on a promissory note, *Helvering* v. *Blumenthal*, 296 U.S. 552, 56 Sup. Ct. 305 (1935). But more than this, *Burnet* v. *Wells*, *supra*, looked beyond the category of legal obligation and, with four dissents, found the constitution unsullied though the settlor was taxed upon income directed to the liquidation of his "social" obligations. The ill-defined limits of this extension make the future efficacy of the irrevocable trust perhaps as questionable as is that of the revocable; at the very least the step the court has taken presages taxability for the settlor in any situation where the trust device is employed in the realization of a transaction sufficiently institutionalized to justify the view that the trust provision constitues a form of saving to its creator. See 22 Iowa L. Rev. 390, 393; *Pillsbury* v. *Burnet*, 67 Fed. (2d) 151 (App. D.C. 1933); *Cummins* v. *United States*, 78 Ct. Cl. 268 (1933); *Thacker* v. *United States*, 78 Ct. Cl. 284 (1933).

With the trust device in this predicament, there will inevitably develop an increasing search for more satisfactory modes of income tax avoidance. Since 1913, the Revenue Acts have carried a provision, now Revenue Act of 1936, Sec. 181, to the effect that, "Individuals carrying on business in partnerships shall be liable for income tax only in their individual capacity." Though designed to meet the problem of taxation of the ordinary business partnership, the availability of this section as a lawful device for the "spreading of income" should, in the future, suggest itself to draftsmen more than it has in the past.

The possibilities offered by this provision, in so far as past litigation can point the way, are best analyzed by a consideration of two decisions in the Circuit Court of Appeals, *Comm'r.* v. *Olds*, 60 Fed. (2d) 252

(C.C.A. 6th, 1932), and *Humphreys* v. *Comm'r.*, 88 Fed. (2d) 430 (C.C.A. 2d, 1937). In the earlier case, the father, owning extensive lumber interests, agreed with his three daughters to sell them each a one-fourth interest in his property. The daughters, in return, executed demand non-interest bearing notes for $400,000 each. The business was to be conducted solely by the father who was to made distribution of profits over and above their necessary expenses as he saw fit. Anyone of the daughters could withdraw from the agreement if dissatisfied with the management of the business, in which case the notes were to be returned. A divided Court held this to be a partnership within the meaning of the Revenue Act. In the later case, Humphreys, Day, and their respective wives agreed to enter into the business of public accounting and tax counseling attorneys. The wives contribtued the original capital, but the firm was later reorganized, all the parties contributing to the capital and agreeing in return to share the profits and losses. The principal control was necessarily retained by the husbands as their wives were neither lawyers nor accountants, but the women had some voice in the employment of the staff and in other less important affairs of the firm. The court held this also to be a partnership for income tax purposes.

A partnership inter se is a relationship existing by virtue of an expressed or implied contract between two or more persons to carry on a business for profit. Gilmore on Partnership, Sec. 1; Douglas, "Vicarious Liability," 38 Yale L.J. 720. The Uniform Partnership Act which has been adopted in nineteen states defines a partnership as, "an association of two or more persons to carry on as co-owners a business for profit." U.L.A. Partnership Sec. 6. In the *Humphrey case*, it seems clear that the parties entered into a contractual relationship which was binding on all. On the other hand, the *Olds* case does not present so obvious a situation. Whether in fact a contract of partnership existed depends upon the enforcibility of the notes given by the daughters, since the detriment incurred by virtue of liability on the notes could constitute the only possible consideration supporting the partnership contract. The majority of the court in that case held the notes valid and, consequently, the contract of partnership sustainable. The dissenting judge was of the opinion that the notes were supported by illusory promises and therefore unenforceable, basing his view upon the power of the daughters to withdraw from the agreement in case of dissatisfaction with the management of the business. I Williston, Contracts (Rev. Ed.) 124 is, however, authority for the proposition that a provision revocable on dissatisfaction does not impair validity, since the good faith required to prove dissatisfaction is sufficient to ground a good promise. But the finding of a valid

contract of partnership, though essential, does not of itself demonstrate ordinarily the existence of a partnership; there must also be apparent certain other indicia. One of these may be co-ownership. Co-ownership of the firm property arises out of a contribution to its capital. In the *Olds* case it does not appear that the daughters contributed anything to the capital, and so the dissenting judge declared, for the agreement to sell was insufficient in form to carry the legal title of the property to them. Under the agreement employed the father merely placed the property in the partnership and took the notes in consideration of the contract of sale. This was an attempt to short circuit the two separate steps necessary to the result desired, and might have proved disastrous had the majority of the court scrutinized the agreement more closely or emphasized the taint attaching to such direct method of tax avoidance. On the other hand, the facts of the *Humphreys* case plainly shows that the wives contributed property to the original capital. While this money may have come to them through their husbands, there is no indication that a prior gift of the capital by the husbands would have altered the court's attitude. In fact the court in the *Olds* case went so far as to say that a gift of the property contributed to the firm's capital would have been satisfactory. The source of the capital contributed has not been considered of importance in the Board of Tax Appeals' determinations. *Phelps* v. *Comm'r.*, 13 B.T.A. 1248 (1928); *Harrington* v. *Comm'r.*, 21 B.T.A. 260 (1933). But if either the gift or the sale device is used caution would suggest that the plan adopted in the *Olds* case of simultaneous transactions should be avoided; the transaction designed to lay the basis for satisfaction of the requirement of co-ownership should be separated in time from that of the formation of the partnership.

Furthermore, net profit sharing is now generally conceded to be "cogent, often conclusive evidence," that the enterprise is being carried on for the participants. *Cox* v. *Hickman*, 8 H.L. 268, 11 Eng. Rep. 431 (1860); *Harvey* v. *Childs*, 28 Ohio St. 319, 22 Am. Rep. 387 (1876); or as the Uniform Act expresses it (Sec. 7 (4)), profit sharing is prima facie evidence of a partnership. In the *Humphreys* case the contract specifically provided for profit sharing. In the *Olds* case the memorandum provided that each daughter was to have such profits as their father "sees fit to pay them, and as they may have need for their living and comforts." If this constituted a right to share profits it was prima facie evidence of a partnership and the only remaining question would be the extent to which the alternative explanation of a gift would constitute a rebuttal. This explanation would, however, contradict the intent expressed in the memorandum as well as the obvious purpose to avoid a surtax.

A further test of business partnership is that of co-control. Thus the exercise of some control by the wives in the *Humphreys* situation was emphasized by the court as demonstrating the existence of a genuine partnership. In the *Olds* case the two prevailing judges could point to little control in the hands of the daughters but nevertheless declared it to be their opinion that, "It is not essential to the validity of a partnership agreement that the right to control a business * * * be equal." Support for such an attitude can apparently be found in Board of Tax Appeals rulings, the Board has held that sharing of control need not be shown, *Cobb* v. *Comm'r.*, 9 B.T.A. 547 (1927); *Kahn* v. *Comm'r.*, 14 B.T.A. 125 (1928); *MacPherson* v. *Comm'r.*, 19 B.T.A. 651 (1930), unless the control exercised by the one party takes on the characteristics of dictatorship. *Tally* v. *Comm'r.*, 22 B.T.A. 712 (1931). Partnership for tax liability and for tort liability involve different legal and economic factors, and a case might be made for the proposition that the emphasis upon co-control as a condition precedent to imposition of tort liability is not relevant to the problem of interpreting the partnership section of the Revenue Acts. Be this as it may, the significant fact from the tax avoidance angle is that under Sec. 181 a draftsman can satisfy the requirements of co-control for tort liability and still reserve for the taxpayer partner a degree and type of control impossible with the trust device. If the suggestion of the *Olds* case be employed, namely sale with notes, as it undoubtedly can be with impunity by insuring their enforceability, there is available to the taxpayer a method of control roughly equivalent to that so unsuccessfully attempted in the revocable trust cases. Through reservation of a power to force a dissolution of the partnership, the father and/or husband could at any time cause legal title to the capital to revert back to the various members of the family; he could then proceed against the other members in satisfaction of the notes he holds.

While there are thus definite possibilities for "spreading" of income in the partnership section, certain limitations upon the usefulness of this device are also apparent. *Burnet* v. *Leininger*, 285 U. S. 136, 52 Sup. Ct. 345 (1932), reveals one such limitation. In that case the husband, a partner in an existing laundry firm, agreed to give his wife one-half of his interest therein, she to be entitled also to share the profits and bear the losses equally with him. The Supreme Court of the United States held this was not a partnership under the Revenue Act since there was no transfer of the *corpus* of the partnership property to a new firm with the consequent readjustment of rights in that property and in its management. Lower federal courts have not only held similarly at various times, *Harris* v *Comm'r.*, 39 Fed. (2d) 546 (C.C.A. 2d

1930); *Mitchell* v. *Bowers*, 15 Fed. (2d) 287 (C.C.A. 2d 1927); they have declared that neither an assignment of the taxpayers' "entire interest" *Battleson* v. *Comm'r.*, 62 Fed. (2d) 125 (C.C.A. 9th 1932); nor his agreement to hold his interest in trust for a third party, *Balkwell* v. *Comm'r.*, 77 Fed. (2d) 569 (C.C.A. 6th 1935), will give tax immunity. The doctrine underlying these determinations, that there must be an assignment of the income-producing property itself, is a general one, see Surrey, *supra*, and accords with the requirement of a bona fide co-ownership discussed above. Its peculiar significance in the case of a partnership already in existence for other reasons lies in the fact that a rearrangement for purposes of tax avoidance cannot be had short of dissolution of the then existing partnership. Seldom is such a step free of difficulties.

The courts have held in the non-tax field that the contract of partnership of an infant is voidable, but the extent of this avoidance has been expressed by divergent views. Mathew's Revision of Mechem's Cases on Partnership, p. 492, note. But in the tax field the Board of Tax Appeals, in *Lidov* v. *Comm'r.*, 16 B.T.A. 1421 (1929), held that a child of tender years could not qualify as a partner under Sec. 181. But this restriction can be avoided by use of a trust for the children as was done in *Reeb* v. *Comm'r.*, 8 B.T.A. 759 (1927). The father created a trust for the benefit of a minor child of his and turned the property over to the mother who was named trustee. She, having broad discretionary powers as to investments, then placed a part of the *corpus* in the family partnership. The court sustained this partnership arrangement. It might be suggested that possibly it would be more desirable to have a guardian appointed to carry out the same purpose, especially since the courts will usually scrutinize such trust devices.

The most significant limitation on the usefulness of the family partnership device lies in the apparent power of Congress to tax as a unit either the family or a partnership. Nothing in *Hoeper* v. *Wis. Tax Comm.*, *supra*, stands in the way; taxing as a unit does not mean the taxing to A of the income of B but the taxation of the family or partnership as an entity, each member then paying a proportionate part of the tax in accordance with his share of the income. Such a plan was presented to Congress in 1934, but no action was taken on it.

Analysis of the cases in this field thus reveals that until Congress acts, a wealthy person having property in his own name and not an interest in a then existing partnership should be able to find shelter within Sec. 181 so as to "spread" his income and still retain a surprising amount of control over it.

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