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## CAPITAL CONTRIBUTIONS AND "BUSINESS PURPOSE" IN FAMILY PARTNERSHIPS

By FLOYD K. HASKELL\*

### I. INTRODUCTION

ON February 25, 1946, the Supreme Court announced its decisions in *Commissioner v. Tower*<sup>1</sup> and *Lusthaus v. Commissioner*<sup>2</sup> and thereby dashed the hopes of taxpayers who had seized on the family partnership device as a means of reducing surtaxes. The Court's avowed purpose, to resolve the conflicting principles enunciated by the lower courts was, to a large extent, accomplished; however, in so doing, the Court, as was inevitable, raised new problems to trouble Bench and Bar alike.

Although in *Tower* and *Lusthaus* the Court held that no valid partnership existed, recognition was not withdrawn from all family partnerships. The Court stated that if the wife or other family member:

"... either invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things she may be a partner as contemplated by 26 U. S. C. §§ 181, 182."<sup>3</sup>

This pronouncement immediately posed three problems—(1) when are a family member's services sufficient to require recognition of the partnership, (2) when does capital "originate" with the family member so that she may be considered a partner for income tax purposes, and (3) what contributions qualify as "capital contributions"?<sup>4</sup>

Generally speaking, the answer to the first problem may be

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1. 327 U. S. 280 (1946).

2. 327 U. S. 293 (1946).

3. *Commissioner v. Tower*, 327 U. S. 280, 290 (1946).

4. The income-splitting feature of the Revenue Act of 1948 eliminates as of January 1, 1948, the family partnership problem when the partners are spouses. This relief, however, is not retroactive. Furthermore, the problem continues to exist when the partners are other than spouses. As suggested by one author, the effect of this Act will probably be a decreasing volume of litigation in the family partnership field coupled with an increasingly vigorous attack on the part of the Treasury when the family partners are other than spouses. Pedrick, *The Revenue Act of 1948, Income Estate and Gift Taxes—Divided They Fall*, 43 Ill. L. Rev. 277, 291 (1948).

For discussion of the income-splitting feature of this Act, see Pedrick, *ibid.*; Durrey, *Federal Taxation of the Family—The Revenue Act of 1948*, 61 Harv. L. Rev. 1099 (1948); Alexander and Greenfield, *Marital Deductions, Split Income and the Revenue Act of 1948*, Practising Law Institute (1948).

found by asking the question—are the family member's services such that, if performed by a third party, the third party could command a partnership interest?<sup>5</sup> The second and third problems are more difficult and it is with them, though primarily with the second, that this article is concerned.

## II. THE TOWER AND LUSTHAUS CASES

Although the facts of these cases are widely known, it will probably be of assistance to refresh the reader's recollection.

In the *Tower* case the husband owned and operated a business which manufactured and sold sawmill machinery and wood and metal stampings. He had managed and controlled the business since 1927, and had operated it from 1935 to 1937 in corporate form, owning 445 out of the 500 outstanding shares. In 1937 his tax consultant advised that dissolution of the corporation and formation of a partner with his wife would result in substantial tax savings.

Pursuant to this recommendation, the husband transferred on August 25, 1947, 190 shares to his wife on condition that the corporate assets received on dissolution be placed into a partnership in which she would be a partner. Three days later a limited partnership was formed, the wife receiving a partnership interest identical with her interest in the corporation. A gift tax return was filed and a tax paid.

The Tax Court found that no valid partnership existed and upheld the determination of the Commissioner that the entire income from the business was taxable to the husband. This decision, having been reversed by the Sixth Circuit; was affirmed by the Supreme Court.<sup>6</sup>

In the *Lusthaus* case the husband operated a furniture business at Uniontown, Pennsylvania. In 1939, being confronted with the

5. Mertens, *The Law of Federal Income Taxation* § 35.09 (1st ed. 1942, Supp. 1948) see cases cited footnotes 22g and 22h.

6. The Supreme Court, after reviewing the facts of *Tower*, stated at page 287:

"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 partnership. This finding of fact, since supported by evidence, is final."

The Court cited and relied on *Dobson v. Commissioner*, 320 U. S. 489 (1943), *rehearing denied*, 321 U. S. 231 (1944). In this case the Supreme Court limited review of Tax Court decisions. The extent of this limitation in this and other classes of cases, since it would be the subject of another article, will not be discussed. Congress has recently abolished the *Dobson* rule and, effective September 1, 1948, Tax Court decisions are reviewable ". . . in the same manner and to the same extent as decisions of the District Courts in civil actions tried without a jury . . ." 26 U. S. C. A. § 1141 (1948).

prospect of large profits, he, his accountant and his attorney worked out a plan for a family partnership. The husband executed a bill of sale purporting to sell an undivided interest in this sole proprietorship to his wife, and at the same time a partnership agreement was entered into between husband and wife. The husband borrowed \$25,000.00 from a bank and gave his wife a check for \$50,000.00. The wife then gave the husband her check for slightly in excess of this amount together with eleven notes of \$5,000.00 each. The Tax Court found that these notes were given with the understanding that they were to be repaid out of the profits of the business. After formation of the partnership the wife continued to assist at the stores as she always had done; however, by virtue of the partnership agreement, the husband retained full control of the business.

The Tax Court upheld the Commissioner's determination that the entire income of the business should be taxed to the husband. This decision was affirmed successively by the Third Circuit and by the Supreme Court. Mr. Justice Reed wrote a dissenting opinion in which he was joined by then Chief Justice Stone. This dissent applied to both *Tower* and *Lusthaus*.<sup>7</sup>

Since one of our problems concerns the question of when capital "originates" with a family member, the possible source of capital which a family member contributes to a partnership must be examined. Certain capital contributions clearly originate with the contributors and others equally clearly do not. Inevitably, there are border-line cases. To illustrate this, five possible sources of capital belonging to a family member are set forth. These are:

- (1) Capital owned by a wife prior to marriage, or acquired by a family member from some person other than the head of the family.
- (2) Capital earned by the wife after marriage, or by another family member at any time.
- (3) Capital given by the family head in the form of an interest in his business enterprise when operated in corporate form.
- (4) Capital given by the head of the family in assets unrelated to his business.

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7. Section 142 of the Revenue Revision Bill of 1948 (H.R. 6712), passed by House of Representatives last spring, adopts in a general way the minority view and validates both prospectively and retroactively, family partnerships falling within the detailed provisions of the section. If that section should become law, the majority of family partnership problems would be resolved. It is important to note, however, that the section sets up detailed standards and if these are not strictly complied with, the taxpayer must look to *Tower* and *Lusthaus* for the resolution of his problem. Furthermore, in view of the composition of the 81st Congress, the chances of this section becoming law are remote.

- (5) Capital given by the family head in the form of an interest in his business when operated as a sole proprietorship or as a partnership.

Clearly capital acquired as in the first two categories "originates" with the family member, and the courts have so held. Equally clearly capital acquired as in the fifth category does not "originate" with the family member and therefore its "contribution" will not validate a family partnership. This is the holding of *Lusthaus*.

The third and fourth categories remain. Is capital so acquired to be considered, when contributed to a partnership, as capital "originating" with the family member? That an answer be found is of great practical importance; for the usual, rather than the unusual, source of a family member's capital is a gift from the head of the family.

Furthermore, except for a few fortunate individuals who are by inheritance wealthy, the majority of the businessmen of this country have accumulated their own wealth, and this accumulation is on the whole represented in their individual business enterprises. Thus, when these individuals make gifts to their families the corpus of the gift is, more often than not, an interest in their business.

Since prior to 1940 most of these businesses were operated as corporations, the family head frequently gave shares of stock in his enterprise. In 1940, however, the first Excess Profits Tax Act was enacted and to avoid its impact many businessmen decided to forego the limited liability feature of the corporate form, and to do business as individuals. Their corporations were, therefore, dissolved and the stockholders, family members, became partners in the same enterprise.<sup>8</sup>

Is such a family partnership valid for income tax purposes? The family members contributed the capital to the partnership which they received upon dissolution of the corporation. But did this capital "originate" with the family member so as to require recognition of the partnership for income tax purposes?

The other question with which this article deals is what type of contribution qualifies as a "capital" contribution so as to validate a family partnership. Will the lending of credit, the prestige of a name or other intangible but valuable contribution qualify?

The answers to these questions are not expressly given in the

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8. History in this respect will undoubtedly repeat itself if the 81st Congress enacts another Excess Profit Tax. Furthermore, The Revenue Act of 1948, by providing that the income of spouses may be split and by reducing individual, but not corporate, tax rates, had made the corporate form a less attractive way of doing business. As a result, many small corporations may dissolve and the family members become partners.

Supreme Court's opinion, and can only be found by an application of the legal principles underlying *Tower* and *Lusthaus*.

Of course, if these cases represent mere judicial fiats, as at least one court apparently believes,<sup>9</sup> no definite answer can be given. However, it is submitted that these decisions embody legal principles and follow precedents well established in tax law, and that, therefore, the questions may be answered.

Without doubt Mr. Justice Reed's carefully written dissent,<sup>10</sup> if adopted, would give to the Court's decision the appearance of a judicial fiat. He points out that the gifts of husband to wife were, in both cases, complete and valid gifts; that in the *Lusthaus* case the validity of the gift was not questioned, and that in the *Tower* case the Court treated the genuineness of the gift as immaterial to its decision.

Mr. Justice Reed further points out that no contention was made in either case that the income was solely due to the personal services of the husband, saying:

"While the Tax Court pointed out that the income resulted in part from Petitioner's managerial ability it also recognized that the capital contributed to the earnings."<sup>11</sup>

Indeed, the nature of both businesses indicates that capital must have been an income-producing factor.

Mr. Justice Reed points out that, therefore, both *Lucas v. Earl*<sup>12</sup> and *Helvering v. Horst*<sup>13</sup> are inapplicable, saying:

"It is essential, too, we think, to note that in these partnership cases the tax doctrine of *Lucas v. Earl*, 281 U. S. 111, 115, as to the attribution of income fruit to a different tree from that on which it grew is inapplicable. Here, so far as the income is attributable to the property given, the gift cannot be taken as a gift of income before it was earned or payable, as in *Lucas v. Earl*, 281 U. S. 111; *Helvering v. Horst*, 311 U. S. 112; *Helvering v. Eubank*, 311 U. S. 122, where the income was held taxable to the donor. It was a gift of property which thereafter produced income which was taxable to the donee, as in *Blair v. Commissioner*, 300 U. S. 5. . . ."<sup>14</sup>

In the *Lucas* case, where a lawyer assigned one-half of his future income to his wife, the Court held that since the husband earned the income he should be taxed thereon. In the *Horst* case, where a father gave his son a bond coupon but not the bond, the

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9. *Fletcher v. C. I. R.*, 164 F. 2d 182 (2d Cir. 1947).

10. *Lusthaus v. Commissioner*, 327 U. S. 293, 297 (1946).

11. *Id.* at 299.

12. 281 U. S. 111 (1930).

13. 311 U. S. 112 (1940) and its companion case, *Helvering v. Eubank*, 311 U. S. 122 (1940)

14. *Lusthaus v. Commissioner*, 327 U. S. 293, 298 (1946).

Court held that, since the father kept the income-producing property, the income was taxable to him.

In *Tower* and *Lusthaus*, on the other hand, in an economic sense, the income-producing property was given. Therefore, Mr. Justice Reed's statement that *Earl* and *Horst* are inapplicable cannot, it is submitted, be controverted.

Mr. Justice Reed then discusses *Helvering v. Clifford*,<sup>15</sup> the other major case relied on by the Court. There the taxpayer established a short term trust for his wife, appointed himself trustee with wide managerial powers, and provided that at the end of the term the property should revert to him. The Court found that the taxpayer retained so many of the rights of ownership over the property that he should be taxable on the trust's income. Mr. Justice Reed distinguishes this case on the following grounds:

"The husband was the managing partner but had no control otherwise over the distribution of assets on dissolution or of withholding her share of the earnings when distributed. Before distribution they were her earnings held subject to her right to an accounting and *taxable to her under the Revenue Laws*. This distinguishes the case from the short term trust of *Helvering v. Clifford*, 309 U. S. 311. Management of a business which involves only the risk of the capital of another is not the control to which the *Clifford* case refers." (Emphasis supplied)<sup>16</sup>

Presumably, when Mr. Justice Reed stated that the wife's share of the income was "taxable to her under the Revenue Laws," he was referring to Section 182. This Section directs that a partner's share of partnership profits be included in his individual income and taxed to him. Thus, if the wife is a partner, the statute requires that the income be taxed to her. Therefore, unless some principle of tax law precludes recognition of the wife as a partner, the *Clifford* case must be distinguished and the Court's decision does, indeed, appear to be a mere judicial fiat.

### III. STATUTORY BACKGROUND

A study of Congress' special treatment of partnerships in the Internal Revenue Code, and a study of the language of the specific statutory provisions relating to partnerships will, it is submitted, reveal the basis of the *Tower* and *Lusthaus* decisions. The relevant sections will, therefore, be set out in full. Section 3797(a) (2) defines partnership and partner as follows:

"The term 'partnership' includes a syndicate, group, pool, joint venture or other unincorporated organization, through or by means

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

16. *Lusthaus v. Commissioner*, 327 U. S. 293, 303 (1946).

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 syndicate, group, pool, joint venture or organization."

Section 181 specifically exempts partnerships from taxation, and Section 182 taxes to each partner his distributive share of partnership income:

Section 181. "PARTNERSHIP NOT TAXABLE. Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

Section 182. "TAX OF PARTNERS. In computing the net income of each partner, he shall include, whether or not distribution is made to him—

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in Sec. 183 (b)."

Thus Congress' treatment of partnerships is unique; all other income-producing entities and organizations are taxed—individuals, corporations, estates and trusts. That Congress could tax partnerships cannot be doubted since its Constitutional power to tax, if the tax is not confiscatory, is limited only by the requirement of reasonable classification.<sup>17</sup> Congress chose, however, to exempt partnerships from taxation.

Furthermore, it should be borne in mind that a partnership is defined by Congress as an organization by means of which a "business, financial operation, or venture is carried on." The significance of this language and special treatment will be discussed in the succeeding section.

#### IV. ANALYSIS OF THE TOWER AND LUSTHAUS CASES

##### A. Gregory v. Helvering

The *Tower* and *Lusthaus* cases, it is believed, represent an application of the "business purpose" doctrine first enunciated in

17. 1 Mertens, *op. cit. supra* note 5, § 4.09. Although the Internal Revenue Code does not tax partnerships as such, it is interesting to note that partnerships were taxed by the 1917 Excess-Profits Tax Act, 39 Stat. 1000 § 201 (1917) and that New York State (Article 16-A, N. Y. Tax Law) imposes a tax on unincorporated business organizations.

Furthermore, in many respects, under the present Federal Income Tax Laws, partnerships are treated as separate tax entities. See Rabkin and M. H. Johnson, *The Partnership Under the Federal Tax Laws*, 55 Harv. L. Rev. 909 (1942). This special treatment of partnerships appears to have been only once challenged on Constitutional grounds, *W. W. Guy, Adm.*, 13 B. T. A. 51 (1928), *aff'd*, 35 F. 2d 139 (4th Cir. 1929). In that case the Board of Tax Appeals brushed aside the taxpayer's Constitutional argument on the grounds that the classification was reasonable; and, although the taxpayer appealed, he apparently did not think enough of his Constitutional argument to raise it in the Circuit Court.



*Gregory v. Helvering*,<sup>18</sup> and the Supreme Court, finding no business purpose to the formation of the partnership, held that no partnership existed "under the Revenue Laws."<sup>19</sup>

The *Gregory* case involved the reorganization provisions, first enacted in the Revenue Act of 1918 and now found, as amended, in Section 112 of the Internal Revenue Code. Prior to the enactment of these provisions, the most minor changes brought about by corporate reorganization, even though affecting in no way the stockholders' interests, resulted in the recognition of gain and taxable income. To remedy this inequity, Congress enacted these provisions and postponed recognition of income until gain was actually realized.

Ingenuous taxpayers soon found ways to take advantage of these provisions and to put money in their pockets without paying taxes. The *Gregory* case was such a transaction. There the well-advised taxpayer created a temporary corporation to receive certain securities from another corporation which she controlled. Having received the securities, the temporary corporation was liquidated. The sole purpose of the "reorganization" was to enable the taxpayer to receive these securities free from the regular dividend tax.

Although the transaction conformed in all respects to the letter of the statute, the Supreme Court held that no "reorganization" had taken place on the ground that there was no "business or corporate purpose" to the transaction.<sup>20</sup> This requirement of "business or corporate purpose" was judge-made. No such requirement is found in the statute; nor do the committee reports specifically mention such need. Despite this, there are few today who will question the validity of the Court's decision.

This principle is readily applicable to the formation of partnerships. Section 3797(a) (2) defines partnerships as organizations by means of which any "business, financial operation or venture" is carried on. Thus, a partnership is an organization through which a "business" is carried on, and to insist on a "business purpose" to

18. 293 U. S. 465 (1935). The Supreme Court's most recent pronouncement on the subject is *Bazley v. C. I. R.*, 331 U. S. 737 (1947). For a discussion of this case, as well as the background and history of the doctrine, see Spear, "Corporate Business Purpose" in *Reorganization*, 3 Tax L. Rev. 225 (1948).

19. A conflicting viewpoint, *i.e.*, that *Tower* and *Lusthaus* may be supported solely on the "substantial ownership" doctrine of the *Clifford* case, is presented in a note in 41 Ill. L. Rev. 669 (1947). However, in view of the statutory treatment of partnerships in the Internal Revenue Code, the writer does not consider that the *Clifford* doctrine alone can provide the basis for these decisions.

20. *Gregory v. Helvering*, 293 U. S. 465, 469 (1935).

the formation of a partnership requires far less reading of Congressional intent than in the reorganization situation.

Furthermore, Congress specifically exempted partnerships from the impact of the Federal Income Tax Laws, and provided that partnership income be taxed only to the individual partners. Thus, the analogy to the reorganization situation is complete. In view of this statutory scheme and specific language of the statute, the partnership situation actually provides a stronger case for the application of the *Gregory* principle than did the *Gregory* case itself.

What, then, establishes the existence of a business purpose for the formation of a partnership? The contribution of capital or the rendition of valuable service would, for either of these, as a matter of business practice, entitle the contributor to a partnership interest. Furthermore, the contribution of credit, prestige, or any other intangible of value constitutes a business reason for granting a partnership interest. On the other hand, when a family member is given a partnership interest, no business purpose to partnership formation exists. For, as stated by the Supreme Court, no capital not previously available for the business is contributed, no vital services are contributed, and the relationship of the family to the income is unchanged.

It is submitted that the Supreme Court had this requirement of business purpose in mind when it stated the issue in the *Tower* case:

"If as respondent asserts, the circumstances surrounding the formation and operation of this partnership were such as to bring it within the meaning of Sections 181 and 182 of Title 26 of the United States Code, then the respondent and his wife are liable only for their respective individual share of the business' income."<sup>21</sup> and when it defined a partnership:

"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 a community of interest in the profits and losses."<sup>22</sup>

and when it concluded:

"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. . . ."<sup>23</sup>

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21. 327 U. S. 280, 282 (1946).

22. *Id.* at 286.

23. *Id.* at 292. Although the Supreme Court refused to pass on the question of whether the facts of these cases would have supported a different finding by the Tax Court, the majority in effect appears to have held, as stated by Mr. Justice Rutledge, that as a matter of law no partnership

Absent a business purpose, no partnership existed within the meaning of Sections 3797(a)(2), 181 and 182; and the income was not taxable to the wife under Section 182(c). Therefore, since the income was not taxable to the wife "under the Revenue Laws," Mr. Justice Reed's grounds for distinguishing the *Clifford* case do not appear to be sound.

This raises the next question—since no partnership exists, and since the Revenue Laws do not provide that the wife's distributive share of the income be taxed to her, to whom is the income taxable? The answer to this question, in a situation where capital is an income-producing factor, may be found in the *Clifford* case.

#### B. Helvering v. Clifford

In discussing the applicability of the *Clifford* doctrine to family partnerships no exhaustive analysis of the cases will be attempted.<sup>24</sup> Not only will space not permit,<sup>25</sup> but such an analysis is unnecessary. For our purposes, an examination of the doctrine as developed by the Supreme Court will suffice.

In the *Clifford* case the husband established a five-year trust for his wife, the corpus of which was to revert to himself at the end of the term. He appointed himself trustee with discretionary power to accumulate income for the beneficiary, but provided that upon the trust's termination all income should be paid to his wife. The trust instrument had a spendthrift clause, conferred wide powers of investment and management upon the settlor, and contained an exculpatory clause for all but "willful and deliberate" breach of duties by the trustee. The Supreme Court stated the issue as:

"whether the grantor, after the trust has been established, may still be treated as the owner of the corpus."<sup>26</sup>

The Tax Court had held that the husband was the owner of the corpus and that the income should be taxed to him. The Supreme Court found a basis for the Tax Court's decision and affirmed. In

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existed for income tax purposes and that the reason therefore was the absence of business purpose to the partnership formation.

24. Although distinguishable on their facts, the difficulty, if not the impossibility, of such a task can be appreciated by comparing courts' varying approaches in such cases as *Estate of J. B. Weil v. C. I. R.*, 145 F. 2d 240 (6th Cir. 1944), *cert. denied*, 323 U. S. 793 (1944), and *Stockstrom v. C. I. R.*, 148 F. 2d 491 (8th Cir. 1945), *cert. denied*, 326 U. S. 719 (1945) (note Judge Sanborn's concurring opinion) and *Stockstrom v. C. I. R.*, 151 F. 2d 353 (8th Cir. 1945) with court's approaches in such cases as *U. S. v. Morse*, 159 F. 2d 142 (1st Cir. 1947) and *Cushman v. C. I. R.*, 153 F. 2d 510 (2d Cir. 1946).

25. See Shepard's United States Citation under 309 U. S. 311.

26. 309 U. S. 331, 334 (1940).

so doing, the Court emphasized that no one fact was controlling, saying:

"Our point here is that no one fact is normally decisive but that all considerations and circumstances of the kind we have mentioned are relative to the question of ownership and are appropriate foundations for findings on that issue."<sup>27</sup>

The bundle of rights retained by the settlor was sufficient to justify a finding that he was the "owner."

"The bundle of rights which he retained was so substantial that respondent cannot be heard to complain that he is the 'victim of despotic power when for the purpose of taxation he is treated as owner altogether.'"<sup>28</sup>

Judge Learned Hand's interpretation of the *Clifford* doctrine, enunciated within a year after the decision was announced, is significant. Judge Hand stated:

". . . the Court must look to the whole nexus of relation between the settlor, the trustee and the beneficiary, and if it concludes that in spite of their changed legal relations the three continue in fact to act and feel toward each other as they did before, the income remains the settlor's; . . . while it is true that the prime consideration is whether the income remains within the family, there are two other circumscribing factors; the length of the term and the powers of management reserved to the settlor. We think that these factors are complementary; the longer the term, the more important the reserve powers, and vice versa."<sup>29</sup>

That no one factor is controlling in determining that the settlor is owner of the income under the *Clifford* doctrine is nicely illustrated by four Second Circuit cases, three of which were decided one year after *Clifford*, and the fourth, two years thereafter.

In one of these cases the settlor retained no reversionary interest;<sup>30</sup> in two others,<sup>31</sup> no control was retained except through the trustee who, in one case, was the settlor's husband and in the other her lawyers; in the fourth case<sup>32</sup> the beneficiaries were not close relations. Yet, in all these cases the Second Circuit upheld the Commissioner's determination that the trust income was taxable to the various settlors.

27. *Id.* at 336.

28. *Ibid.*

29. *Helvering v. Elias*, 122 F. 2d 171, 172-73 (2d Cir. 1941), *cert. denied*, 314 U. S. 692 (1941).

30. *C. I. R. v. Buck*, 120 F. 2d 775 (2d Cir. 1941).

31. *Helvering v. Elias*, 122 F. 2d 171 (2d Cir. 1941), *cert. denied*, 314 U. S. 692 (1941); *C. I. R. v. Barbour*, 122 F. 2d 165 (2d Cir. 1941), *cert. denied*, 314 U. S. 691 (1941).

32. *C. I. R. v. Lamont*, 127 F. 2d 875 (2d Cir. 1942) where the term was one year and the Court relied heavily on the *Earl* and *Horst* doctrines as well as *Clifford*.

When in 1942, the Supreme Court decided *Helvering v. Stuart*,<sup>33</sup> additional light was thrown on the *Clifford* doctrine. One of the trusts involved was created by a father for his children who had attained their majority. The settlor retained no reversionary interests. The corpus of the trust consisted of stock in the Quaker Oats Company of which the taxpayer was an officer and stockholder. The trustees, being the taxpayer, his wife and his brother, were granted broad managerial powers. The taxpayer retained the right to purchase from the trust, upon substitution of property of equal value, the Quaker Oats stock.

The Commissioner argued, on the basis of *Clifford*, that the trust's income was the taxpayer's. The Court stated that the relationship between beneficiaries and settlor alone was insufficient to tax the trust income to the settlor:

"So broad a basis would tax to a father the income of a simple trust with a disinterested trustee for benefit of his adult child. No Act of Congress manifests such an intention."<sup>34</sup>

The Court then stated that "non-material satisfactions" were not a sufficient basis upon which to find the settlor the owner for the purposes of Section 22(a):

"Economic gain realized or realizable by the taxpayer is necessary to produce a taxable income under our statutory scheme. That gain need not be collected by the taxpayer . . . The 'non-material satisfactions' (gifts—contributions) of a donor are not taxable as income. *Helvering v. Horst*, supra."

"That economic gain for the taxable year, as distinguished from the non-material satisfactions, may be retained through control of a trust so complete that it must be said that the taxpayer is the owner of its income. So it was in *Helvering v. Clifford*, 309 U. S. 331, 335, 336. . . ."<sup>35</sup>

The Court stated that control of the Quaker Oats stock might be economically so important to the settlor that the trust income should be taxed to him:

"Control of the stocks of the company of which the grantors were executives may have determined the manner of creating the trusts. Paragraph eight permits recapture of the stocks from the trust by payment of their value. . . . Family relationship evidently played a part in the selection of the trustees. On the other hand, broad powers of management in the trustees, even though without adverse interest, point to complete divestment of control, as does the impossibility of reversion to the grantors. The inter-locking trustees were not appointed simultaneously. The triers of fact

33. 317 U. S. 154 (1942), *opinion amended*, 317 U. S. 603 (1942) *rehearing denied*, 317 U. S. 711 (1942).

34. *Id.* at 168.

35. *Ibid.*

have made no finding upon this point. Cf. *Helvering v. Clifford*, supra. . . ."<sup>36</sup>

The Supreme Court thus made it clear that there must be some economic gain, i.e., material satisfaction, in order to apply the *Clifford* doctrine. The Court's opinion indicates that the presence or absence of power to recapture the corpus is not determinative, but that control, by means of a trust, of a corporation, in which the taxpayer is interested, would be a sufficient basis to tax the trust income to the settlor.

Since the *Stuart* case, cases have come before the Circuit Courts where the settlor retained no reversionary interest, but controlled a corporation through a trust. *Edison v. C.I.R.*,<sup>37</sup> was such a case. The corpus of the trust was stock in Edison Bros. Stores, Inc., of which the settlor, through the trust, controlled 40,576 of the 385,490 shares outstanding. The Tax Court found that control of this stock, plus the management powers retained by the settlor, might have been of great importance, and, therefore, taxed the income to him. The Eighth Circuit affirmed.

Judge Learned Hand, speaking for the Second Circuit,<sup>38</sup> has stated that control, through a trust, of the stock of a corporation in which a taxpayer-settlor was interested would permit the Tax Court to find that the taxpayer was "owner" of the corpus.

Our problem is whether the *Clifford* doctrine, as amplified by *Stuart*, is applicable to a family partnership which is valid under state law but which, since its formation lacked business purpose, is invalid for Federal income tax purposes.

The gift of a partnership interest is not a gift for a term of years with a reversion in the donor. However, the *Stuart* trust contained no reversionary feature, and yet the Supreme Court stated that the *Clifford* doctrine could be applied. On the other hand, in the family partnership cases, as in *Stuart*, there existed a family relationship between donor and donee. But, as demonstrated by *Stuart*, this, alone, is not a sufficient ground upon which to tax the income to the donor.

Control, then, is the determining factor. In both *Stuart* and the family partnership cases, the question is whether the control is "so complete that it must be said that the taxpayer is the owner of its (trust or partnership) income." In *Stuart*, the Tax Court had

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36. *Id.* at 169.

37. 148 F. 2d 810 (8th Cir. 1945), *cert. denied*, 326 U. S. 721 (1945).

38. *Kohnstamm v. Pedrick*, 153 F. 2d 506 (2d Cir. 1945); *but see Cushman v. C. I. R.*, 153 F. 2d 510 (2d Cir. 1946), where Judges Chase, Swan and Frank comprised the Court, and where Judge Frank dissented primarily on the basis of Judge Hand's opinion in *Kohnstamm*.

made no finding as to the extent or importance of the settlor's control of the Quaker Oats Company through the trust; therefore, the case was remanded.<sup>39</sup>

Control of a corporation by means of being able to vote its stock is closely analogous to the control of the managing partner over the business affairs of a partnership. Both the managing partner and the controlling stockholder can determine the policies of the business, can hire agents to carry out these policies, and can thereby directly affect their individual economic status. As a matter of fact, economic gain through control is more immediate in the case of a managing partner, since there is no intervention of the corporate entity. By proper management of the family member's interest, both managing partner and controlling stockholder can add to the income resulting from the interest retained. Furthermore, both can maintain their positions in the business world—sometimes a matter of considerable financial importance.

Control being as great in the family partnership cases as in *Stuart*, the income, once it is established that the formation of the partnership had no business purpose, may, by virtue of the *Clifford* doctrine, be taxed to the donor. The bundle of rights vested in the donor of a family partnership interest is at least as great as required by the Supreme Court in *Stuart*.

There does exist, however, one factual difference between the *Stuart* situation and the family partnership cases. A donor who transfers stocks in trust retaining directly or indirectly control over the trusts can be assured, if the trust's term is of sufficient length, that he will retain this control for his lifetime. On the other hand, in *Tower* and *Lusthaus*, the donee-wives could, after the expiration of the partnership term, demand a distribution of assets and thus divest their husbands of control over the business. Furthermore, if the agreements had been one of general partnership, without any provision conferring exclusive managerial powers on the husband-donors, the donors' exclusive control would last only as long as the donees permitted.<sup>40</sup>

To the extent, then, that the control of the donor is temporary, the family partnership situations differ from *Stuart*; and, if this

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39. The Tax Court found, 2 T. C. 1103 (1943), that the settlor was not taxable on the trust income since, including the Quaker Oats stock held by the trust, he and his immediate family had only 5.4% of the company's outstanding stock.

40. Since deficiency determinations always involve specific fiscal or calendar periods, it may be argued that, if the taxpayer has control during those periods, he is the "owner" for the purposes of Section 22(a), and that it is immaterial that he may be divested of control sometime in the future.

distinction is considered material, the family partnership cases are, to this extent, an extension of the *Clifford* doctrine beyond the *Stuart* case.

### C. Summary and Application of the Foregoing Analysis

As discussed heretofore, family partnership situations raise two issues. These are:

- (1) Whether the business organization is a partnership as that word is used in the Internal Revenue Code.
- (2) If it is not, then whether the income may be taxed to the family head.

The first may be resolved by applying the business purpose test formulated by the Supreme Court in the *Gregory* case. As discussed, the statutory treatment of partnerships, and the specific language of the relevant sections provide a proper background for the application of this principle. The question is, therefore, whether there was a business purpose to the formation of the partnership, or, to state the proposition differently, whether the family member made such contribution to the business enterprise as to be entitled, under general business practice, to a partnership interest.

If this is answered affirmatively, then a partnership exists "under the Revenue Laws," and Section 182 requires that each partner be taxed on his distributive share. The second issue is thus automatically resolved.

On the other hand, if no business purpose to the partnership formation is found, no partnership exists "under the Revenue Laws." Thus the second issue becomes of importance. May the income be taxed to the family head? The answer to this question will be found by applying either the *Earl-Horst* doctrine or the *Clifford* doctrine.

If the income of the business is the result of personal services the *Earl* doctrine applies, and the income is taxed to the earner. On the other hand, if capital is an income-producing factor, and an interest in the partnership assets has been given, *Earl* and *Horst* are inapplicable; for, in such a situation, income is not due to service alone, nor has income been separated from income-producing property. The *Clifford* doctrine, therefore, remains. There the question is whether "the benefits directly or indirectly retained blend so imperceptibly with the normal concepts of full ownership" that the "triers of fact" may find the taxpayer the "owner of the corpus for the purposes of Section 22(a)."

As previously discussed, this doctrine, as elaborated in *Stuart*, is applicable by reason of the family relationship between the



donor and donee, and because of the control retained by the donor over the business enterprise. On the other hand, if the family relationship between donor and donee is not close, and if no real control is retained by the donor, then, even though there was no business purpose to the partnership formation, the income should be taxed to the donee, the owner of the property.

Our problem is to determine, in the light of this analysis, under what circumstances capital "originates" with a family member, and what contributions are "capital" contributions, so that the family member's partnership interest must be recognized for tax purposes. Specifically, must the family partnership be recognized, (1) when the contributed capital was previously given by the family head to the family member in assets unrelated to the business enterprise, (2) when the contributed capital was previously given by the family head to the family member in the form of a stock interest in the predecessor corporation, and (3) when the contribution by the family member is of credit, the prestige of a name, or other intangibles?

As to the first two situations, it should be observed that property is no less a family member's for having been given by the family head than for having been acquired in any other manner. This is true for tax as well as other purposes. Nor do the income tax laws purport to tax to a father or husband, on the basis of relationship alone, the income from property given by him to his family.<sup>41</sup> This principle was emphatically restated by the Supreme Court in the *Stuart* case.<sup>42</sup> Thus, capital acquired by a family member from the family head differs in no respect from other property belonging to the family member.

Furthermore, when an individual contributes capital to the hazards of a business enterprise, or when he contributes vital service, it is business custom to award to him a partnership interest. The partnership is valid for income-tax purposes, and Section 182 requires that his distributive share of partnership income be taxed to him. The fact that the contributor happens to be a family member does not alter the result, and, thus, the Supreme Court stated that if the capital contributed "originates" with the family member, a valid income-tax partnership exists. There being the same business purpose to the formation of the partnership, Section 182 taxes the income to the family member.

The fact that the capital so contributed and subjected to the

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41. *Blair v. Commissioner*, 300 U. S. 5 (1937).

42. 317 U. S. 154, 168-69 (1942).

risks of the business was previously acquired as a gift from the family head should make no difference. As has been noted, the property is no less the family member's for having been received as a gift. Nor is the risk any less because the capital contributed was so acquired. Thus the same business purpose to the partnership formation exists as in the case where the family member contributes property acquired from any other source. It, therefore, follows that a valid partnership exists "under the Revenue Laws," and that the income must be taxed to the family member and not to the family head.

Nor should the result differ because the property previously given by the family head was stock in a predecessor corporation. The stock, after it was given, became the property of the family member as completely as if the corpus of the gift had been government bonds. The family member, upon dissolution of the corporation, could withdraw the capital represented by her share from the business enterprise. In electing not to do so, she contributed her own capital to the partnership, and this contribution in no way differs from a contribution of any other type of property.

The same result should obtain whether the contribution is of physical assets, good will, credit, or any other intangible of value; for the test is that something of value be contributed.<sup>43</sup> If something of value is contributed it is business practice to award a partnership interest. There exists a business purpose to the partnership formation.

Where a family member's partnership interest is disproportionate to the capital contribution, and no vital services are rendered, the entire interest should not be recognized. The excess, unless the result of real negotiations and bargaining, is a gift and, to this extent, no business practice or purpose entitles the family member to so large a partnership interest. Under these circumstances the Court should allocate to the family member the percentage of partnership interest fairly attributable to capital contributed; the remainder should be disallowed. This practice has been adopted by the Tax Court when the capital contributed is originally acquired from a source other than the family head;<sup>44</sup> the

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43. See *Hartz v. C. I. R.*, 170 F. 2d 313 (8th Cir. 1948) where banks contracted their lines of credit due to the objection of the State Banking Commission that they were extending too much credit to a "one-man" business. To overcome this objection, the taxpayer took his family into the partnership, whereupon his lines of credit were secured. The Eighth Circuit reversed the Tax Court and held that a partnership existed for income-tax purposes.

44. *W. B. Woosley*, 5 T. C. M. 1058 (1946), *rev'd*, 168 F. 2d 330 (6th

fact that the capital originally was a gift from the family head should make no difference.

As a test of the above analysis, let us assume a situation where a family member pays a sum of money to the family head and receives in return a partnership interest in his business. Assume further that the business earnings were large and the purpose was to reduce taxes; that the family head invests the purchase price in government bonds, thus achieving security with a small return on his capital.

The partnership should be valid for tax purposes. Since the family member has subjected his or her capital to the hazards of the business, the business purpose for the formation of a partnership is the same as in any other situation where capital is contributed. The tax-avoidance motive should not alter the result. The Supreme Court, both in *Gregory* and in *Tower*, emphasized that the tax-avoidance motive was not the invalidating factor. In *Gregory*, the Court stressed that the invalidating factor was the absence of business purpose; and our analysis of *Tower* indicates that the same lack invalidated the family partnership. It has been stated many times that when a tax-avoidance motive accompanies a transaction, otherwise valid, the nature of the transaction is not altered.<sup>45</sup> Therefore, the above partnership should be recognized for tax purposes.

As another example, let us assume that a mother has inherited a manufacturing business from her husband, that her son is the active head of the business, and that the mother gives the son's

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Cir. 1948); *Claire L. Canfield*, 7 T. C. 944 (1946), *rev'd*, 168 F. 2d 907 (6th Cir. 1948); *David L. Jennings*, 10 T. C. 505 (1948).

The Sixth Circuit in both *Woodsley* and *Canfield* reversed the Tax Court's decisions to the extent that they prorated partnership income according to capital contributions. See also *Hartz v. C. I. R.*, 170 F. 2d 313 (8th Cir. 1948). Despite this, it is not considered that these decisions hold that the Tax Court, once it finds that a partnership exists, may not allocate income in a ratio other than specified in the partnership agreement. In the *Woodsley* case the Sixth Circuit pointed to the wife's valuable managerial services, and in the *Canfield* case not only did the Court emphasize the value of the wife's services but make much of the wife's "insistence" that she be a partner. In both decisions the Sixth Circuit adverted to the fact that cases could arise where the Tax Court might properly allocate income other than as specified in the partnership agreement. In a recent decision the Tax Court adverted to *Woodsley* and *Canfield* and stated that these cases did not preclude a partial reallocation, in all situations, of partnership income in a manner different from the partnership agreement. See *Edgar C. Minton*, T. C. Memo Op., CCH Dec. 16582 (M) (1948).

45. For a recent affirmation of this principle, see *T. W. Rosborough*, 8 T. C. 136, 144 (1947) where the Court said: "But, a motive to minimize taxes will not vitiate a transaction where the reduction of taxes is but a normal consequence of the transaction, otherwise real, complete, and bona fide in every respect."

wife and child a partnership interest. Since the wife and child make no original contribution to the business, there exists no business purpose to the formation of the partnership, and thus no valid income-tax partnership. Must the income be taxed to the donor? In answering this question it should be noted that the family relationship between donor and donees is not extremely close. Furthermore, since the son is the active head of the business, the donor-mother does not retain control of the enterprise; nor would such control be of any value to her. Therefore, under the *Clifford* doctrine, as elaborated in *Stuart*, the donor is not the "substantial owner" of the property. It follows, then, that the income should be taxed, not to the donor, but to the donees, the real owners of the property. Substantially, this set of facts very recently came before the Eighth Circuit. That Court, though it did not expressly discuss business purpose, rightly held that the income was taxable to the daughter-in-law and grandchild, respectively, and not to the grandmother.<sup>46</sup>

As a further test of our analysis, let us assume that an active business man gives a partnership interest to a total stranger. Since the stranger makes no original contribution to the enterprise, no business purpose to the partnership formation exists. Thus Section 182 of the Code does not require that the income attributable to the donee's partnership interest be taxed to the donee. To whom then is the income taxable?

Assuming that the business income was not attributable solely to the donor's personal services, but that capital was a material income-producing factor, and assuming that the interest given was not just an interest in income but was an interest in capital, *Earl* and *Horst* are inapplicable. Furthermore, two of the three elements of *Clifford* are lacking. There is no family relationship, and the donor has retained no reversionary interest.

The Supreme Court has said, however, that no one factor is controlling. Hence, the issue would seem to be whether the control retained by the donor was sufficient to justify a finding by the Tax Court that the donor is the "substantial owner" of the property for the purpose of Section 22(a).

If the donor put the interest in trust, retained individually the power to manage the business, appointed himself trustee with broad powers, including the right to change the beneficiary to anyone other than himself or his estate, retained the right to distribute or withhold income, and reserved the right to substitute property of

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46. *Walsh v. C. I. R.*, 170 F. 2d 535 (8th Cir. 1948).

equal value for the corpus of the trust, it is submitted that the Tax Court could properly find the donor the "owner" and tax the entire business income to him. On the other hand, if the control retained was not extremely substantial, the *Clifford* doctrine could not be applied and, even though, because of the absence of business purpose, no income-tax partnership existed, the income would have to be taxed to the donee, the owner of the property.

#### V. CONTRIBUTION CASES AND JUDICIAL ANALYSES OF TOWER AND LUSTHAUS

The Courts appear to agree that when any real contribution is made by the family member, whether or not of capital previously received from the family head, and whether or not the contribution is of intangibles, the partnership is valid for Federal income-tax purposes.

In *Harry Shulak*,<sup>47</sup> the first of its type to be decided after *Tower and Lusthaus*, part of the capital contributed by the wife to the partnership formed in 1940 was given her in 1936 by her husband, and another part she had saved, subsequent to 1936, from household allowances. The Tax Court found that the wife was a partner for income-tax purposes, saying:

"... we do not think that the idea of the origin of partnership capital with the partner to be taxed requires refusal to consider the long-standing of the gift from which partnership capital is paid. The question being essentially one of good faith and reality of the partnership, it is clear that the gift of money in 1936 was not with any idea of contribution thereof to any partnership, but with true donative intent; . . . The same logic applies to the \$1500 saved, without his knowledge, from household savings. There was clearly no intent, in so saving, to contribute capital to a partnership, or to evade taxes by so doing."<sup>48</sup>

In the foregoing case the Court's decision was somewhat assisted by the wife's contribution of services. In *S. E. Booser*,<sup>49</sup> however, no question of services was raised and the issue, as stated by the Court, was:

The primary question in the instant case is whether petitioner's wife and sister contributed capital originating with them to the partnership enterprise.

The Court, pointing out that the 1937 gift of stock exchanged in 1941 for partnership interest in a different enterprise was complete and valid, held as follows:

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47. 5 T. C. M. 328 (1946).

48. 5 T. C. M. 331 (1946).

49. 6 T. C. M. 1020 (1947).

"We are not here, therefore, confronted with a situation where the arrangement for family participation in a partnership was made for the express purpose of reducing taxes and as an incident to that arrangement a purported gift of an interest in the partnership was made by the husband to the wife . . . We also think it clear that each of the women invested her own capital, which was capital originating with her within the meaning of *Commissioner v. Tower*, supra."<sup>50</sup>

Only three cases, all decided by the Sixth Circuit, have been found where the capital contributed had been previously given by the family head in the form of stock in a predecessor corporation. The one discussed here is *Lawton v. C.I.R.*<sup>51</sup> The partners were a husband, his wife, two sons, two daughters, and a stranger. In 1937 the husband gave 400 shares of the stock of his corporation to his wife, and 50 shares to each of his four children. Additional shares were transferred to the children in 1938 and 1939. The corporation was liquidated in 1940 and a partnership formed. The Tax Court taxed the wife's and daughters' shares of the income to the husband on the grounds that the gifts of stock were not real. The Sixth Circuit reversed the Tax Court, stating that the gifts were valid,<sup>52</sup> and saying:

"It must be noted that when the stock transfers were made in 1937, 1938 and 1939, there was no thought of dissolving the corporation and creating a partnership . . . The gifts of stock made by Lawton to his wife and children and the gifts made by Mrs. Lawton were valid, whether considered purely as gifts or in consideration of substantial services, and being valid Mrs. Lawton and her daughters made substantial contribution to the capital of the partnership and are, for tax as for other purposes, partners."<sup>53</sup>

In the *Lawton* case most of the stock of the predecessor corporation was given three years prior to the formation of the partnership; in the *Boozer* case and the *Shulak* case most of the capital was given by the family head four years prior to the formation of the partnership.

Does the elapse of a substantial amount of time between the gifts and partnership formation control the result? It is submitted that it does not, and that the issue is whether the gifts were made in contemplation of the partnership formation. If the gifts were so made, the principle of *Commissioner v. Court Holding Com-*

50. *Id.* at 1026.

51. 164 F. 2d 380 (6th Cir. 1947).

52. See Mario Morano, T. C. memo op. Dock. No. 13810 (June 29, 1948) where the Tax Court held a gift of stock incomplete and taxed the subsequent partnership income to the family head in a situation similar to the *Lawton* case, despite the fact that the Circuit Court had drawn "different inferences of fact from the record and reversed our decision."

53. 164 F. 2d 380, 385 (6th Cir. 1947).

pany<sup>54</sup> applies, *i.e.*, that what is essentially one transaction cannot, for tax purposes, be divided into several transactions. The result will be to disallow the family member's partnership interest on the grounds that in reality the gift was of a partnership interest.

The Sixth Circuit Court<sup>55</sup> has disallowed a family member's interest on this basis. There the gift was made twenty months prior to the formation of the partnership, but at the time of the gift the matter of forming a partnership for the purpose of reducing taxes was discussed. The Court, citing the *Court Holding Company* case and the *Dobson*<sup>56</sup> case, affirmed the Tax Court's decision:

"The taxpayers vigorously contend that the gifts of stock and the formation of the partnership are totally separate proceedings and should not be viewed as a unified transaction, stressing the fact that the gift to Mrs. Lowry preceded by almost a year the gift to Mrs. Sligh. But it was a question of fact whether the various steps in these transactions were separate or a part of one plan requiring that they be viewed as a unit. Hence the decision on this point rested with the Tax Court."<sup>57</sup>

The same Circuit has, however, sustained a family partnership where the capital contributed was given the family member on the eve of the partnership formation.<sup>58</sup> The Court found that at the time of the gift no family partnership was contemplated, that circumstances changed rapidly so that the capital given to the family member was needed by the family head, and that, therefore, the ensuing family partnership was valid for tax purposes.

Since *Tower* and *Lusthaus*, the flood of family partnership cases has by no means abated. If anything, it has increased. Probably for this reason no extensive judicial analysis of these decisions appears to have been attempted.<sup>59</sup> Despite this, however, the relevance and importance of the business purpose doctrine has been widely recognized. To date this recognition has been primarily given in cases where services were relied on to support the partnership;<sup>60</sup> in situations involving capital contributions, the Courts

54. 324 U. S. 331 (1945).

55. *Lowry v. C. I. R.*, 154 F. 2d 448 (6th Cir. 1946).

56. See note 6 *supra*.

57. *Lowry v. C. I. R.*, 154 F. 2d 448, 449 (6th Cir. 1946).

58. *Kent v. C. I. R.*, 170 F. 2d 131 (6th Cir. 1948).

59. Recent District Court decisions have adopted the view that the rendition of services or contribution of capital by the family member is not controlling, and has but an evidentiary bearing on the question of whether the parties "really and truly" intended to form a partnership. This view is subscribed to neither by the Tax Court nor the Circuit Courts, and has resulted in decisions not reconcilable with *Tower* and *Lusthaus*, *Riggs v. Thompson* (E.D. Ark., April 14, 1948); *Cooke v. Glenn*, 78 F. Supp. 519 (W.D. Ky. 1948).

60. In *Culbertson v. C. I. R.*, 168 F. 2d 979 (5th Cir. 1948), the Fifth Circuit upheld a family partnership on the grounds that services were to be

apparently have felt it unnecessary to go behind the word, "originate."

The Tax Court has repeatedly referred to the importance of business purpose. In one case it upheld a family partnership, saying:

"Their services strike us as substantial and vital under the circumstances. The reason for their entry appears to us to have served a legitimate and valid business purpose."<sup>61</sup>

In another case the Tax Court sustained a family member's interest, saying:

"There were cogent and compelling business reasons for re-forming the entire partnership to include him. His knowledge of the various phases of the needle trade industry, his wide experience . . . united to make his services to Lee invaluable."<sup>62</sup>

On one occasion the Tax Court disallowed a family partnership on the express grounds that no business purpose existed, saying:

"Aside from the fact that this testimony is largely hypothetical and opinion in nature, it fails to convince us that any genuine business purpose was or could be accomplished by taking petitioner's daughter into the business."<sup>63</sup>

The Fourth Circuit in a per curiam opinion upheld the Tax Court's disallowance of a family partnership, saying:

"No business purpose was served by the petitioner's transfer to the minor daughter of a portion of his interest in the partnership. The conduct, control and management of the partnership business went on just as it did before the transfer. All that the daughter did was to receive her share of the partnership income."<sup>64</sup>

The Eighth Circuit, in a case where the family member's presence in the partnership was necessary to secure adequate bank credit, upheld the partnership, saying:

"Our difference arises from a failure by the Tax Court to find and give due deference to the uncontroverted evidence that this partnership was created in good faith for the purpose of obtaining

rendered but that the actual rendition was prevented by the war. Although future services were not specifically mentioned by the Supreme Court, nevertheless such certainly constitute a business purpose to the partnership formation and come within the rationale of *Tower* and *Lusthaus*. See also Isaac Blumberg, 11 T. C. No. 80 (1948).

61. Mack Perlman, 6 T. C. M. 1120 (1947).

62. Margaret F. Horowitz, 6 T. C. M. 642 (1947); see also T. W. Rosborough, 8 T. C. 136 (1947).

63. Robert Le Sage, 6 T. C. M. 1263 (1947); see also Walter F. Reidel, 10 T. C. No. 147 (1948), where the Tax Court found some but not enough evidence of business purpose.

64. *Wilson v. C. I. R.*, 161 F. 2d 556, 557 (4th Cir. 1947); it appears, however, that once no business purpose is found to exist, the Fourth Circuit would tax the income to the family head on the basis of the *Earl* doctrine, whether or not capital was an income-producing factor. See *Economos v. C. I. R.*, 167 F. 2d 165 (4th Cir. 1948).



necessary working capital to insure the continued existence of the business."<sup>65</sup>

The Fifth Circuit,<sup>66</sup> on the other hand, apparently does not consider business purpose germane to the issue, but believes that the *Earl-Horst* and *Clifford* doctrines are sufficient bases upon which to rest its decisions.

## VI. CONCLUSION

In conclusion, the foregoing analysis indicates that the *ratio descendit* of the family partnership doctrine is:

- (1) That a partnership to be valid under the Internal Revenue Code must have a business purpose to its formation, and
- (2) That, absent a business purpose, the question of whose income it is must be resolved under the *Earl* doctrine, if capital is not an income-producing factor, and under the *Clifford* doctrine if it is.

If this analysis is correct, any capital contributed by a family member, whether acquired by a gift from the family head or otherwise, and whether tangible or intangible, "originates" with the family member and thus entitles the family member to a partnership interest. The reason for this is that, where capital is an income-producing factor and is contributed to the business, the contributor is, as a matter of business practice, entitled to a partnership interest. There being a business purpose to the formation of the partnership, a valid tax partnership exists, and Section 182 of the Code requires that the income be taxed to the family partner.

The absence of judicial analyses of *Tower* and *Lusthaus*, perhaps due to the volume of such cases coming before the Courts, is unfortunate; for, because of the resulting confusion, the advisor in tax matters can do little more than guess whether the facts of his client's case will strike the Court as similar or dissimilar to the facts of *Tower* and *Lusthaus*. It is hoped that this article will eliminate some of the confusion in this field.

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65. *Hartz v. C. I. R.*, 170 F. 2d 313, 318 (8th Cir. 1948).

66. *Scherf v. C. I. R.*, 161 F. 2d 495 (5th Cir. 1947); *Benson v. C. I. R.*, 161 F. 2d 821 (5th Cir. 1947); *Culbertson v. C. I. R.*, 168 F. 2d 979 (5th Cir. 1948), *cert. granted*, 17 U. S. L. Week 3168 (U. S. Dec. 7, 1948).