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Taxation - Family Partnerships

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TAXATION—FAMILY PARTNERSHIPS*—Taxpayer, a Texas rancher, had operated a cattle business in partnership with a non-family member. During the latter part of 1939, the partnership was dissolved upon the condition that the taxpayer, Culbertson, would sell an undivided one-half interest in the herd to his four sons. The sons gave their father an interest-bearing note for one-half interest in the new partnership. This note was paid in the following manner: credit for overcharge $5,930; gifts from taxpayer $21,744; and one-half of a loan procured by the new partnership, Culbertson & Sons, $30,000. The loan was repaid from the proceeds from the operation of the ranch. The oldest son performed services for the partnership until he entered the army. The second son went into the army directly from college and rendered no 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, applying the dual test of "original capital" and "vital additional services" disallowed any division of income and held the entire income of the partnership taxable to the father.[1] The Court of Appeals for the Fifth Circuit, reversing the tax court, recognized the partnership tax wise, for the court found that the partnership was formed "with the full expectation and purpose that the boys would, in the future, contribute their time and services to the partnership."[2] The Supreme Court disagreed with the tax court and the court of appeals and remanded the case to the tax court to determine which, if any, of taxpayer's sons were partners with him in the operation of the ranch during the taxable years involved, 1940 and 1941. *Commissioner v. Culbertson*, 69 S.Ct. 1210 (U.S. 1949).

The remand was based on the query as to which of the sons, if any, "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."[3]

Mr. Chief Justice Vinson, speaking for a divided court,[4]

* See Prentice Hall Tax Service ¶ 70,515 (1949) for a tabulation of family partnership cases decided since the *Culbertson* case.

1. T.C. Memo. Decision Docket Nos. 4184, 4185 (1947).

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

3. 69 S.Ct. 1210, 1217 (U.S. 1949).

4. Although Black and Rutledge, J.J., concurred, they expressed the view that the tax court properly applied the principles of the *Tower* and *Lusthaus* decisions. Burton, J., concurred, stating that there was nothing as a matter of law that would preclude the tax court from finding that the

asserted that the true test of a valid partnership for tax purposes is intent—whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[5] Although the *Tower*[6] and *Lusthaus*[7] cases were affirmed, the Supreme Court criticized the tax court for emphasizing the dual test of "original capital" and "vital services" and omitting any consideration of "management and control." "The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[8] The Supreme Court then pointed out that the tax court never made "even an oblique reference to any lack of intent on the part of respondent and his sons to combine their capital and services 'for the purpose of carrying on the business.'"[9]

The court relied on the *Tower* case to overthrow the position of the court of appeals. "If it is conceded that some of the partners contributed neither capital nor services to the partnership during the tax years in question, as the court of appeals was apparently willing to do in the present case, it can hardly be contended that they are in any way responsible for the production of income during those years. . . . our decision in *Commissioner v. Tower* clearly indicates the importance of participation in the business by the partners during the tax year. We there said that a partnership is created 'when persons join together their money, goods, labor, or skill for the purpose of carrying

income was properly taxable on a partnership basis. Frankfurter, J., concurred in a separate opinion, making more explicit the appropriate legal criteria of a partnership for income tax purposes. Jackson, J., dissented, taking the view that the ordinary common law tests of validity of partnerships are the tests for tax purposes and that they were met in this case.

5. 69 S.Ct. 1210, 1214 (1949). Cf. approach taken (in theory) by the Bureau of Internal Revenue in 1947. I.T. 3845, 1947-1 Cum. Bull. 66.

6. Commissioner v. Tower, 327 U.S. 280, 66 S.Ct. 532, 90 L.Ed. 670, 164 A.L.R. 1135 (1946).

7. Commissioner v. Lusthaus, 327 U.S. 293, 66 S.Ct. 539, 90 L.Ed. 679 (1946).

8. 69 S.Ct. 1210, 1214 (U.S. 1949).

9. Id. at 1215.

on a trade, profession or business and where there is community of interest in the profits and losses.'"[10] It should be noted that this language is couched in terms of a present contribution of capital or services. To hold otherwise would be a violation of the fundamental principle that income must be taxed to him who earns it.[11]

The *Culbertson* case makes it clear that in order for a partnership to be recognized tax wise, the partners must contribute either capital or services; nevertheless the requisite capital may have been acquired by gift—even where the gift was in connection with the creation of the partnership.[12] However the opinion warns that transactions between members of a family will be carefully scrutinized since "the family relationship often makes it possible for one to shift tax incidence by surface changes of ownership without disturbing in the least his dominion and control over the subject of the gift or the purposes for which the income from the property is used."[13] How is the taxpayer going to prove that the gift was not a mere "camouflage"? The court indicated the answer, stating, "If the donee of property who then invests it in the family partnership exercises dominion and control over that property—and through that control influences the conduct of the partnership and the disposition of its income—he may well be a true partner. Whether or not he is free to and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise."[14] Apparently, a donee will not be allowed to delegate his control over the donated property, even though it is generally considered that a donee who delegates managerial powers to another, but retains the right to revoke or limit those powers at any time, is still the true owner. A more practical test would be whether the donee has the *right* to exercise control, rather than the actual *exercise* of it.[15] The Court of Appeals for the Fifth Circuit has had some difficulty in the application of the *Culbertson* case.

10. Id. at 1213.
11. Lucas v. Earl, 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731 (1930); Helvering v. Clifford, 309 U.S. 331, 60 S.Ct. 554, 84 L.Ed. 788 (1940). Cf. Poe v. Seaborn, 282 U.S. 101, 51 S.Ct. 58, 75 L.Ed. 239 (1930).
12. Walsh v. Commissioner, 170 F.(2d) 535 (C.C.A. 8th, 1948). But see Cole v. Commissioner, 173 F.(2d) 893 (C.C.A. 6th, 1949).
13. 69 S.Ct. 1210, 1216 (U.S. 1949). In Edward A. Theurkauf, 13 T.C. No. 70 (1949), the tax court sustained the validity of a partnership where the facts were similar to those in the *Tower* case, the distinguishing feature being that there was no condition attached to the gift.
14. Id. at 1217.
15. Cf. Henson v. Commissioner, 174 F.(2d) 846 (C.C.A. 5th, 1949).

In a recent case it held the income of a partnership taxable to the donor's parents, stating that there was no showing that anyone but the father controlled the capital used in production of the income.[16] After argument on rehearing, the original opinion was vacated and the case was remanded to the district court. Ironically, the court which started the trend towards the "intent" test[17] said very little about intent in its original opinion of the *Ginsburg* case.

Prior to the *Tower* case, a "donee partner" rendering no services could be sustained only if capital was a substantial income-producing factor.[18] This rule will probably hold true under the *Culbertson* decision. Where the income is primarily attributable to capital, the question of services should be immaterial. An interesting problem is presented when the income of the partnership is attributable to both capital and services. Should a reapportionment be required when one partner contributes capital only? This question was raised in the instant case, but the court "intimated no opinion on that subject."[19] The tax court has reallocated income in such cases but this action has found disapproval by the courts of appeal.[20] A probable safeguard against a reallocation by the commissioner would be a provision in the partnership agreement for a reasonable salary for the working partner before the division of profits according to capital invested.

It may well be that the *Culbertson* case is the beginning of a new era in family partnerships and it is hoped that the Bureau of Internal Revenue and the tax court will not again go astray in interpreting the leading decision on the problem. Although

16. Ginsburg v. Arnold, 176 F.(2d) 879 (C.C.A. 5th, 1949), wherein Waller, J., the author of the majority opinion of the *Culbertson* case in the court of appeals, dissented. But see O. H. Delchamps, 13 T.C. No. 39 (1949), where the partnership was upheld where donee partners performed insignificant services.

17. Culbertson v. Commissioner, 168 F.(2d) 979 (C.C.A. 5th, 1948); Walsh v. Commissioner, 170 F.(2d) 535 (C.C.A. 8th, 1948); Isaac Blumberg, 11 T.C. 663 (1948).

18. Robert P. Scherer, 3 T.C. 776 (1944); J. D. Johnston, Jr., 3 T.C. 799 (1944); Davis B. Thornton, 5 T.C. 116 (1945).

19. 69 S.Ct. 1210, 1217.

20. Canfield v. Commissioner, 168 F.(2d) 907 (C.C.A. 6th, 1948). In Woosley v. Commissioner, 168 F.(2d) 330, 333 (C.C.A. 6th, 1948), the court said, "In our judgment the Tax Court clearly erred as a matter of law in attributing to the capital contributions all of the income earned by the partnership and in making the allocation which it did contrary to the express provisions of the articles of partnership." Hartz v. Commissioner, 170 F.(2d) 313 (C.C.A. 8th, 1948), cert. denied 69 S.Ct. 1528 (U.S. 1949).

the Revenue Act of 1948[21] makes the partnership question between spouses principally an academic one, it is still important as between other family members. The latter type of partnership has a far greater chance of recognition tax wise, for "it has been aptly said that 'bed chamber arrangements' between a husband and wife will be viewed with suspicion."[22]

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21. 62 Stat. 110 (1948).
22. Laikin, Tax Pitfalls (1947) 25 Taxes 657.