Vanderbilt Law Review

Volume 2
Issue 2 *Issue 2 - A Symposium on Estate Planning*

Article 5

2-1-1949

Family Partnership v. Corporation--Income Tax Aspects

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FAMILY PARTNERSHIP v. CORPORATION—INCOME TAX ASPECTS

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I. INTRODUCTION

At the outset, it must be emphasized that a decision as to the more desirable mode of doing business should never be based solely upon tax considerations. In every instance, the following legal and practical advantages of transacting business as a corporation must always be borne in mind:

(1) *Limited Liability.* The liability of a stockholder for the debts of the corporation is limited to his investment in its stock, while all of the property of a general partner is subject to the claims of the firm's creditors, if its assets are insufficient to satisfy such claims in full.

(2) *Continuity of Existence.* A corporation may have perpetual existence, since changes in the ownership in its shares, whether resulting from the death of a stockholder or otherwise, have no effect upon the continuance of the corporation. Ordinarily the death or withdrawal of a partner dissolves the partnership but a partnership agreement may provide that the firm shall be continued by the surviving partners.

(3) *Ready Transferability of Shares.* The disposal of the interest of a stockholder in a corporation is a very simple matter, since it merely requires the transfer of his stock to another person, but the sale of a partnership interest usually involves an accounting to determine the value of the retiring partner's share.

These points are, of course, elementary, but perhaps it may be for that very reason that there is a recent tendency in some quarters to minimize them. For example, it has been suggested that, since insurance may now be obtained against most normal business risks, the limited liability element of a family controlled corporation has become of much less weight than in the past. However, this conclusion seems to overlook the high mortality rate of newly organized corporations of moderate size. Statistics indicate that business failure is so prevalent during the early years of young enterprises as to constitute, in itself, one of the most common of business risks. Such failures are often the result of business depression, or other adverse conditions, which are beyond the control of the management, no matter how experienced and able it may be. Insurance cannot be obtained against insolvency, and the freedom of stockholders from liability for the corporation's debts remains today the most reliable shield against the possibility of personal disaster.

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II. Validity for Tax Purposes of Family Partnerships

During the war years family partnerships had a mushroom growth in popularity. This was owing largely to the excess profits tax on corporations, which was repealed as regards taxable years commencing after December 31, 1945. In view of the substantial loss of revenue resulting from the elimination of all corporate taxes by means of the use of family partnerships, the Bureau of Internal Revenue was very active in its endeavor to establish their invalidity for federal income tax purposes. In numerous instances, such family partnerships consisted of a husband, who was the source of the capital and, as the only active partner, contributed all of the technical knowledge, business judgment and managerial skill, and his wife and children, who contributed no services of importance and little or no capital from their own separate funds.

The Bureau's strenuous efforts to invalidate many types of family partnerships led to a myriad of decisions by the Tax Court and by the federal circuit courts of appeals during 1945 and prior years as to the elements which determine the validity of family partnerships for tax purposes. Many of these decisions were in such conflict that it was impossible to formulate a general rule which could be relied upon with any assurance.[1]

Fortunately, however, it is unnecessary to review and analyze this mass of cases, because the present tax status of family partnerships is clearly governed by the companion decisions of the Supreme Court in February, 1946 in *Commissioner* v. *Tower*[2] and *Lusthaus* v. *Commissioner*.[3] These cases established the following test of the validity for tax purposes of family partnerships: Whether the family members, other than the active partner or partners, contributed either (1) vital personal services, or (2) substantial capital originating with themselves.[4]

For the purposes of this article, it will be assumed that a hypothetical family controlled business could not meet this test, and that, accordingly, the proportionate shares of the inactive partners in the partnership's net income would be taxed in their entirety to the active partner.

III. Comparative Taxation of Corporations and Family Partnerships

A. *Corporations*

(1) Tax Advantages

(a) *Accumulation of Income.* By refraining from distributing portions

1. For discussions of the law as of that time, see Hellerstein, *The Tax Status of Family Partnerships*, 17 Rocky Mt. L. Rev. 197 (1945); Polisher, *Family Partnerships*, 22 Taxes 272, 298 (1944), 23 *id.* 46 (1945).
2. 327 U. S. 280, 66 Sup. Ct. 532, 90 L. Ed. 670 (1946).
3. 327 U. S. 293, 66 Sup. Ct. 539, 90 L. Ed. 679 (1946).
4. For general treatment, see Jones, *Family Partnerships—Their Creation and Validity*, 25 Taxes 252 (1947); Miller, *Some Results of the Supreme Court Decisions in the Family Partnership Cases*, 19 Tenn. L. Rev. 510 (1946); Works, *Taxation of Family Partnerships and Family Corporations*, 19 Rocky Mt. L. Rev. 209 (1947).

of a corporation's net income as dividends, the personal income taxes of the stockholders upon the retained portions of such net income may always be postponed, may usually be reduced, and may sometimes be avoided entirely. As will be explained below, this form of tax saving is unobtainable through a partnership.

(b) *Division of Income.* The stockholders of a corporation may reduce their personal income taxes by transferring portions of their stock to other members of their families by gift or otherwise. Where the other family members have little or no income of their own, substantial tax savings may be effected for the family considered as a whole. This is because the federal surtax rates rise progressively as the amount of taxable income increases. The combined income taxes payable by several taxpayers upon their portions of a given amount of income are therefore always less than the single tax which would be payable by one taxpayer upon the whole of such income.

This type of tax saving cannot be accomplished by means of a family partnership which fails to satisfy the test laid down by the Supreme Court in the *Tower* and *Lusthaus* cases. On the other hand, the Bureau has very seldom attempted—and apparently never with success—to nullify the division of corporate income, even when stockholders comprising the management of a closely held corporation gave portions of their stock to family members who were wholly inactive.

(c) *Deferred Payment of Income Taxes.* Individual taxpayers (other than those in very low brackets) are required to estimate their tax on or before March 15th of each taxable year, and to pay the estimated tax in four quarterly instalments, the last of which falls due on January 15th of the following year. Thus individuals are taxed currently. Corporations, on the other hand, are not required to make any payments of income taxes for a given taxable year until the 15th day of the third month following the close of such year, and they may make such payments in four quarterly instalments commencing on that date. This difference in the prescribed times for making tax payments results in giving corporations the use of the funds required to pay each year's taxes for nearly a year longer than in the case of a partner or individual proprietor.

(2) Tax Disadvantages

(a) *Corporation Income Tax.* A corporation is at present subject to tax at rates ranging from 21% of net income, if not in excess of $5,000, to 38%, if in excess of $50,000.

(b) *Double Taxation of Dividend Income.* The corporation income tax applies to the entire net income of a corporation, and no deduction from gross income is allowed for amounts distributed as dividends to stockholders. Any such dividends must be included in the personal returns of the stockholders, who receive no credit for the tax paid by the corporation. The result is that the portion of a corporation's net income which is distributed as dividends is taxed twice.

(c) *Possibility of Penalty Surtax.* There is always a possibility that a corporation may ultimately have to forego the advantage of further accumulation of income, in order to avoid the penalty surtax under Section 102 of the Internal Revenue Code. This tax, which is in addition to the regular corporation income tax, is imposed upon corporations which are "formed or availed of for the purpose of preventing the imposition of the surtax" upon shareholders by means of permitting profits to accumulate. A corporation has the burden of disproving this purpose, if its earnings and profits have been accumulated beyond the reasonable needs of the business. The penalty tax, which applies to the remainder of the net income after deducting the regular corporation income tax and the dividends paid, is at the rate of 27½% of the first $100,000 of such remainder and 38½% of the balance.

There is no statutory provision or established rule of law as to the proportion of a corporation's net income which may be accumulated and added to surplus without risk of the imposition of this penalty tax. In every instance, liability, if it exists at all, depends upon the actual circumstances and business needs of the particular corporation. As a rule of thumb, the Bureau has been instructed to scrutinize the returns of corporations which distribute less than 70% of their net income in form of dividends. This does not mean, however, that every corporation will be subject to the penalty tax which accumulates more than 30%, nor conversely, that every corporation will be free from such tax which distributes at least 70%.

Under ordinary conditions, the average business corporation could probably justify the accumulation of a considerable proportion of its net income on account of one or more reasonable business needs, such as the following: (1) to finance additional business; (2) to procure real property for business use; (3) to liquidate mortgages or other long-term debts; (4) to acquire new machinery and equipment; (5) to provide adequate working capital; or (6) to improve the corporation's financial position.[5]

In this regard, however, the ultimate tax effects of the accumulation of income by a corporation must also be considered. Even though portions of the net income may ordinarily be accumulated without liability to the penalty surtax, it does not necessarily follow that the entire personal income taxes which would have been payable by the stockholders, had such income been distributed in dividends, would be permanently avoided. In the first place; it might be necessary to distribute much of the retained income as dividends in

5. See, in general, Norvell, *Improper Accumulation of Surplus*, 1 VAND. L. REV. 227 (1948).

future years, in order to assure continued freedom from the penalty surtax, if a large earned surplus had accumulated over a long period. In such case, the original accumulation would merely result in postponement of tax to the stockholders with no ultimate tax savings, assuming that the same tax rates would be applicable to such income when distributed.

(d) *Capital Gain Tax Upon Sale of Stock or Liquidation.* Even if the accumulated income could be retained indefinitely, future tax liability might nevertheless result, if any of the stock were sold by a stockholder, or if the corporation were completely liquidated. Capital gain tax would be incurred by the stockholder who sold, or by all of the stockholders (other than a parent corporation) in the case of a liquidation, upon any increase in value of the stock resulting from the accumulation and addition of income to surplus in past years.[6] At present, such capital gain tax would be at the rate of 25% of the increase in value, assuming that the stock had been held for at least six months.

On the other hand, there would never be any tax liability upon the accumulated income, if a stockholder had continued to hold his stock until his death. Upon a person's death, the basis of his property for income tax purposes (usually cost) changes and becomes the value of such property on the date of his death, or one year thereafter in certain instances.[7] Thus, upon a subsequent sale of a decedent's property by its new owner, no tax would ever be imposed upon such portion of the increase in value of the property as had occurred between the date of acquisition of the property by the decedent and his death. However, since sales of stock take place so frequently, it would seem safer to assume that sooner or later any saving of personal income tax through accumulation of income would be partially offset by a capital gain tax.

B. *Family Partnerships*

(1) Tax Advantages

(a) *Freedom from Corporation Tax.* Since partnerships are not treated as separate taxpaying entities, the use of the partnership form avoids entirely the corporation income tax. Thus there is no double taxation where business is done in partnership form.

(b) *No Possibility of Penalty Surtax.* No penalty tax is imposed upon partnerships, regardless of the amount of income that may be accumulated.

(c) *No Capital Gain Tax Upon Certain Liquidations.* Both corporations and partnerships may be organized in such manner as to avoid any capital gain tax upon the original transfer of assets to the enterprise by the stockholders

6. INT. REV. CODE §§ 112(b)(6), 115(e).
7. INT. REV. CODE § 113(a)(5).

or partners. No taxable gain is incurred upon the formation of a corporation, if property (which may consist of interests in a partnership) is transferred to the corporation solely in exchange for the issuance of its stock or securities to the transferors substantially in proportion to their interests in the property transferred, provided the transferors own at least 80% of the corporation's stock immediately after the exchange.[8] The Code contains no specific provision for the non-recognition of gain or loss upon the transfer of property to a newly formed partnership. However, the Regulations clearly recognize that such a transfer does not ordinarily give rise to gain or loss to the partners, because it is provided that the basis of property contributed in kind by a partner to partnership capital is the cost or other basis thereof to the contributing partner.[9]

As previously pointed out, either a sale of stock, or the liquidation of a corporation, gives rise to the realization of capital gain or loss. A sale by a partner of his partnership interest would also result in capital gain or loss, because a partnership interest is not excluded from the definition of a capital asset.[10] Upon the dissolution of a partnership, or the retirement therefrom of a partner, gain or loss is realized by the partner. Such gain or loss is measured by the difference between the price received by the partner for his interest and the sum of the adjusted cost or other basis of his partnership interest, plus the amount of his share in any undistributed partnership net income earned since he became a partner and on which income tax has been paid. However, if a partnership distributes its assets in kind, rather than in cash, a partner realizes no gain or loss until he disposes of the property received in liquidation.[11]

(2) Tax Disadvantages

(a) *Current Taxation of Undistributed Net Income.* As previously mentioned, no tax advantage can be gained by permitting partnership income to accumulate, because each partner's entire distributive share of the partnership's ordinary net income and capital gain is currently taxed to him, whether actually distributed to him or accumulated.[12]

(b) *Taxation of Entire Net Income to Active Partner.* If a family partnership does not satisfy the test established by the *Tower* and *Lusthaus* cases, the entire net income of the partnership would be taxed to the active partner or partners, regardless of the division of income provided for in the partnership agreement.

(c) *Current Payment of Income Tax by Partners.* As mentioned above,

8. INT. REV. CODE §§ 112(b)(5), 112(h).
9. U. S. Treas. Reg. 111, § 29.113(a)(13)-1.
10. INT. REV. CODE § 117(a)(1).
11. U. S. Treas. Reg. 111, § 29.113(a)(13)-2.
12. INT. REV. CODE § 182.

corporations obtain the benefit of the use of funds required to pay a given year's income tax for almost a year longer than in the case of individuals. Since the members of a partnership are taxed as individuals and partnerships are not taxed as such, this advantage of the corporate form cannot be obtained under a partnership.

C. *Comparison of Tax Effects Prior to 1948 Act*

After the repeal of the excess profits tax, which repeal was effective for taxable years commencing after December 31, 1945, and prior to the effective date of the Revenue Act of 1948, the corporate form was often more economical from the tax standpoint, especially in cases where the active family member in a family controlled business had substantial income from other sources. The chief reasons for this were as follows:

(1) *Heavy Tax Burden of Active Partner.* If the partnership was invalid for tax purposes, the shares of its net income to which the other family members were entitled under the partnership agreement would nevertheless be taxed in their entirety to the active member, at the highest surtax rates reached when added to his own net income from the partnership and from all other sources.

(2) *Accumulation of Corporate Income.* A considerable portion, at least, of the corporate net income could presumably be accumulated without danger of incurring the penalty surtax under Section 102.

(3) *Small Cost of Double Taxation to Stockholders in High Brackets.* A stockholder in high income tax brackets would have retained only a small part of the income used to pay his share of the corporate tax, after the payment of his personal tax on such part of the income, if the business had been operated as a partnership.

IV. Illustrative Example

Any estimate of the anticipated income tax effects of doing business in corporate form, as contrasted with a partnership, is obviously contingent upon future events, since numerous uncertain factors are involved which cannot be predicted with any assurance. Therefore, certain rather arbitrary facts must be assumed, in order to provide a basis of comparison between these two forms of doing business. Accordingly, in the examples in this article the following assumptions are made, purely for illustrative purposes, regarding a hypothetical family controlled business and its owners:

A. *Assumptions*

(1) The net income of the business for the taxable year was $100,000.

(2) The respective partnership or stock interests were: husband 40%, wife 30%, son 30%.

(3) The husband's income from other sources was $20,000, after all deductions and exemptions.

(4) The wife had no income from other sources.

(5) The son's income from other sources was $5,000, after all deductions and exemptions.

(6) A corporation could accumulate 30% of the portion of its net income remaining after payment of the corporate tax.

(7) The husband received $20,000 a year as compensation for his services to the family controlled business.

(8) A partnership would not be valid for tax purposes.

(9) Taxes are computed at 1947 rates.

B. *Federal Income Taxes under Family Partnership*

Partnership Net Income	$100,000.
Less Husband's "Salary"	-20,000.
Remainder of Net Income	$ 80,000.

Husband's Tax Status

"Salary" from Partnership		$ 20,000.	
Remainder of Partnership Net Income			
Husband's share (40%)	$32,000.		
Wife's share (30%)	24,000.		
Son's share (30%)	24,000.	80,000.	
Other Income		20,000.	
Net Taxable Income		$120,000.	
Husband's Tax			$80,864.

Wife's Tax Status

Wife's Net Taxable Income	——	
Wife's Tax		——

Son's Tax Status

Son's Net Taxable Income	$ 5,000.	
Son's Tax		1,045.
Combined Taxes under Partnership		$81,909.

C. *Federal Income Taxes under Corporation*

Corporation's Tax Status

Corporate Net Income	$100,000.
Less Husband's Salary	-20,000.

Net Taxable Income	$ 80,000.	
Less Corporation Tax	-30,400.	
Remainder of Net Income	$ 49,600.	
Less Accumulated Income	-14,880.	
Dividends Distributed	$ 34,720.	
Corporation Tax (as above)		$30,400.

Husband's Tax Status

Salary	$20,000.	
Dividends (40%)	13,888.	
Other Income	20,000.	
Net Taxable Income	$53,888.	
Husband's Tax		$28,249.

Wife's Tax Status

Dividends (30%)	$ 10,416.	
Wife's Tax		2,658.

Son's Tax Status

Dividends (30%)	$ 10,416.	
Other Income	5,000.	
Net Taxable Income	$ 15,416.	
Son's Tax		4,679.
Combined Taxes under Corporation		$65,986.

D. *Summary*

Combined Income Taxes under Partnership	$ 81,909.
Combined Income Taxes under Corporation	65,986.
Tax Saving under Corporation	$15,923.

V. Taxation of Corporations and Family Partnerships under Revenue Act of 1948

A. *Federal Income Tax*

Insofar as the division of income between husband and wife is concerned, the corporate form no longer has any income tax advantage over the partnership form, despite the invalidity for tax purposes, of a family partnership. This is owing to the so-called "split income" provisions of the Revenue Act of 1948.

As regards taxable years commencing after December 31, 1947, Section 12(d) provides that, where a joint return is filed by a husband and wife, the combined normal tax and surtax shall be twice the amount that it would have been, if the combined net taxable income were reduced by one-half. Expressed in simpler terms, this means that the combined gross income of a husband and wife electing to file a joint return, less their combined deductions, credits and personal exemptions, is divided by two. A tax is then computed on the resulting amount of net taxable income, with the reductions provided for in Section 12(c), and the actual combined tax payable by the husband and wife is twice the amount of the tax as so computed. Since a joint return may be filed even though one of the spouses has neither gross income nor deductions,[13] the result is that the amendments made by the 1948 Act automatically enable a husband and wife to obtain the maximum possible advantage through the division of their incomes, namely the allocation of 50% of the combined net taxable income to each of them.

The partnership form is somewhat favored by the lower individual tax rates and the increased personal exemptions provided under the 1948 Act. However, assuming that a family partnership would not be recognized for tax purposes, the net tax results of the two forms of doing business are now likely to be quite similar. The choice might well depend largely upon such uncertain factors as the amount of deductible salaries that could be paid by the particular corporation to officer-stockholders, and the amount of income which the corporation could accumulate without risk of the penalty surtax under Section 102 of the Internal Revenue Code.

The family partnership test laid down in the *Tower* and *Lusthaus* cases remains in effect under the 1948 Act. However, when considered in the light of the "split income" provisions, the tax effects upon family partnerships are as follows:

(1) Partnerships Valid for Tax Purposes

(a) *Husband and Wife.* The distributive shares of a husband and wife in the net income of a valid family partnership may be taxed to them either in accordance with the terms of the partnership agreement, or, if they wish, they may combine their entire incomes, including their shares of the partnership's net income, in a joint return, under which their combined income may be split equally between them for tax purposes. There would seem to be no situation in which adherence to the partnership agreement would be preferable to electing the "split income option."

13. INT. REV. CODE § 51(b).

(b) *Other Family Members.* The other partners would be taxed upon their distributive shares of the partnership's net income in accordance with the partnership agreement.

(2) Partnerships Invalid for Tax Purposes

(a) *Husband and Wife.* Even though the family partnership is invalid for tax purposes, a husband and wife may nevertheless elect to combine their entire incomes in a joint return and avail themselves of the "split income" provisions in the same manner as under paragraph 1(a) above. They would naturally make such election, as otherwise both the husband's and wife's shares of the distributive net income of the partnership would be taxed to the husband individually.

(b) *Other Family Members.* The distributive shares of the other partners in the partnership's net income would all be taxed to the husband, or to the husband and wife jointly, depending upon whether they filed separate or joint returns.

B. *Federal Gift Tax*

Under the 1948 Act, husbands and wives may make gifts (including either gifts of partnership interests or of corporate stock) with substantially reduced federal gift tax liability.

(1) *Gifts by Husband or Wife to the Other Spouse.* Only one-half of the value of the donated property is subject to gift tax where the gift is made by either husband or wife to the other.

(2) *Gifts by Husband or Wife to Third Parties.* The husband and wife may, if they wish, elect to treat one-half of the value of the donated property as a gift by each of them. This would, of course, always reduce the combined gift taxes usually by removing one-half of the value of the property from higher gift tax brackets, and always by obtaining an additional $3,000 annual exclusion, unless the gift is of a future interest in property.

VI. Illustrative Example

A. *Assumptions*

For comparative purposes, the same assumptions are made as in the example in Paragraph IV, A above, except that taxes are computed at 1948 rates and that the husband and wife would make a joint return, so as to obtain the benefit of the "split income" provision of Section 12(d).

B. *Federal Income Taxes under Family Partnership*

Partnership Net Income	$100,000.	
Less Husband's "Salary"	-20,000.	
Remainder of Net Income	$ 80,000.	

Husband's and Wife's Tax Status

Husband's Net Taxable Income (as under Paragraph IV, A above)	$120,000.	
Wife's Net Taxable Income		
Combined Income	$120,000.	
One-half of Combined Income	$ 60,000.	
Tax on $60,000	$ 30,182.	
Husband's and Wife's Tax (Twice $30,182)		$60,364

Son's Tax Status

Son's Net Taxable Income	$ 5,000.	
Son's Tax		948
Combined Taxes under Partnership		$ 61,312.

C. *Federal Income Taxes under Corporation*

Corporation's Tax Status

Corporation Tax (as under Paragraph IV, C above)		$30,400.

Husband's and Wife's Tax Status

Husband's Net Taxable Income (as under Paragraph IV, C above)	$ 53,888.	
Wife's Net Taxable Income Dividends (30%)	10,416.	
Combined Income	$ 64,304.	
One-half of Combined Income	$ 32,152.	
Tax on $32,152	$ 12,792	
Husband's and Wife's Tax (Twice $12,792)		$25,584

Son's Tax Status

Dividends (30%)	$ 10,416.	
Other Income	5,000.	
	$15,416	
Son's Tax		4,314
Comhined Taxes under Corporation		$60,298

D. *Summary*

Combined Income Taxes under Partnership	$61,312
Combined Income Taxes under Corporation	60,298
Tax Saving under Corporation	$ 1,014

VII. Proposed Taxation of Family Partnerships and Corporations under Revenue Revision Bill of 1948

A. *Purpose of Proposed Family Partnership Provisions*

The Revenue Revision Bill of 1948 was passed by the House of Representatives at the First Session of the 80th Congress, but was not acted upon by the Senate at either the First or Second Session. According to the Report of the House Committee on Ways and Means,[14] the proposed new Section 191 is designed to eliminate the interpretation placed upon the *Tower* and *Lusthaus* decisions by the tax administrators and the lower federal courts as regards contributed capital. The Report points out that the Bureau and the courts have construed these Supreme Court decisions as limiting the recognition for tax purposes of partner status in a family partnership to those who have contributed capital originating with themselves, or who have performed vital additional services. As mentioned previously, neither the Bureau nor the courts fail to recognize the validity for tax purposes of a completed gift by a husband to his wife of stock in a family corporation, and the dividends paid on such stock are taxed as income to the wife.

It was the Committee's view that this discrimination against family partnerships should be removed, not only with respect to the current and future years, but also for all open years commencing after December 31, 1940. The Report states that proposed Section 191 "is intended specifically to cover cases where capital was given to a relative who then became a partner in a business with the donor," [15] and that, under the bill, members of a partnership of this type will be deemed to be partners for federal income tax purposes, if

14. H. R. Rep. No. 2087, 80th Cong., 2d Sess. (1948).
15. *Id.* at p. 9.

they meet certain prescribed tests. Moreover, the Committee goes further in stating that persons who do not meet such tests are not necessarily denied status as partners.

> "This section does not lay down exclusive rules for determining whether a valid partnership exists for Federal tax purposes. Partners who cannot meet any or all of the tests laid down in the new section may still qualify if they can establish that they would be recognized as partners for Federal tax purposes under the law and decisions without regard to the application of this section." [16]

B. *Tests of a Valid Family Partnership under the Bill*

The tests of whether a partner who is a relative of another member of the partnership may qualify as such under the proposed new Section 191, for any partnership taxable year commencing after December 31, 1947, are, in general, as follows:

(1) He must be 21 years of age or over.

(2) He must be an "individual," which term includes a trust created by the will of a deceased partner, a trust where neither the grantor nor any trustee is a partner or the spouse of a partner, or an estate of a former partner who is deceased or incompetent (other than by reason of minority).

(3) He must have contributed either capital (including money or other property acquired at any time by purchase, bequest, devise, inheritance or bona fide gift from any person even though such person is his partner and relative), or substantial personal services to the partnership.

(4) The partnership agreement must be in writing.

(5) The partnership books must show his contribution to the partnership capital and his interest in its income.

(6) No misrepresentation may be made by any of the partners with respect to his contribution of capital or his interest in the income.

(7) His share of the income (whether distributed or not) must be substantially in proportion to his contribution to the total capital and personal services.

(8) He must have an equal right with other partners who are his relatives to determine whether or not partnership income is to be distributed.

(9) His distributed share of the partnership income (the earnings actually received by him and not left in the partnership) must not be subject to any control by any other partner.

The Committee's Report expresses the view that the foregoing tests represent standards which would ordinarily be followed when forming a non-family partnership and that, to a large extent, they represent tests which the

16. *Id.* at p. 10.

courts now follow in determining whether or not there is a valid partnership.[17]

C. *Retroactive Operation*

As previously pointed out, the proposed new family partnership provisions would operate retroactively with respect to all such taxable years commencing after December 31, 1940 as are not barred by the statute of limitations. In this regard, it is important to note that the tests outlined above are applicable only to partnership taxable years commencing after December 31, 1947. The proposed new Section 191 contains other tests with respect to prior taxable years. While similar, in general, to the foregoing tests, such other tests are not as strict, because the Committee felt that it would be unfair to require partners to meet tests which they could not know existed, unless such tests are essential ones.

The most important difference between the two sets of tests is probably the absence of the test outlined in paragraph (7) above from the tests for retroactive years. This test is not specified as one which must be met to qualify partners for relief under the retroactive provisions. However, if they elect such relief, they will be taxed in the same manner as if the partnership earnings had been divided among the related partners in proportion to their respective contributions to the total capital and personal services rendered. The Committee's report expressed the belief that in past years family partnerships may well have divided earnings in improper proportions, when viewed in the light of the respective contributions to capital and personal services rendered by the various partners, but that such partnerships may nevertheless have been real partnerships. It was therefore felt that, while such partnerships should not be denied the benefits of the retroactive provision, the members thereof should be taxed on distributive shares computed in accordance with the capital contributed, and personal services rendered, by each related partner, in order to insure against the possibility of tax evasion.

D. *Proposed Provisions Regarding Improper Accumulation of Corporate Surplus*

As pointed out earlier in this article, if the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business, that fact, under present law, will result in the imposition of the penalty surtax, unless the corporation can prove by a clear preponderance of the evidence that the earnings and profits were not so accumulated for the purpose of avoiding the surtax upon stockholders.[18]

The Committee was influenced by taxpayers' complaints that the Bureau

17. *Id.* at p. 11.
18. INT. REV. CODE § 102(c).

had been too strict in its interpretation of Section 102, and by reports that the fear of subjecting earnings to the penalty surtax had often resulted in distributions of funds needed by corporations for expansion, protection against possible business decline, or other valid purposes. The bill, therefore, contains three amendments to Section 102, which are designed: (1) to reduce the pressure on corporations to distribute earnings required for genuine business purposes; (2) to free from the penalty surtax any excess of net long-term capital gain over net short-term capital loss; and (3) to permit dividends paid within 75 days after the close of the taxable year to be deducted in computing the "undistributed Section 102 net income," upon which the penalty surtax is imposed.

The first of these amendments would place upon the Commissioner the burden of proving before the Tax Court that an accumulation of earnings and profits is beyond the reasonable needs of the business, in either of the following circumstances:

(1) If, prior to mailing a notice of deficiency, the Commissioner gives the corporation notice of an opportunity to file a statement indicating the grounds upon which the corporation relies as establishing that its earnings or profits have not been accumulated beyond the reasonable needs of the business, and if the corporation files such a statement, and does not rely upon any additional grounds in the Tax Court proceeding.

(2) If the Commissioner fails to give the corporation such notice, even though the corporation has filed no statement.

This amendment, which would be effective for taxable years commencing after December 31, 1947, is intended to assure that the penalty surtax would be imposed upon corporations (other than mere holding or investment companies) only when there is proof of an improper accumulation of surplus. At first glance, it might be thought that this amendment would result in allaying the fears of the corporate world, so that earnings needed in a business would not be so freely distributed in dividends. However, the Bureau's statistieal data shows that the penalty tax has been imposed with success in relatively few cases of corporations actively engaged in the conduct of business, and in practically all of these cases the courts were convinced from the evidence that there had been an unreasonable accumulation of earnings. It is accordingly suggested that merely placing the burden of proof of this issue upon the Commissioner should have little effect upon the outcome of the great majority of Section 102 cases. It would seem that the Commissioner, with or without the amendment, would be unlikely to attempt to impose the penalty surtax, unless he felt that the evidence supported his contention that earnings had been accumulated beyond the reasonable needs of the business.

On the other hand, the tests outlined above show that family partnerships would be most liberally treated under the bill. It would seem that the great majority of existing family partnerships would either already satisfy the prescribed tests in full, or could readily be made to do so. Therefore, under the present corporate tax rates, it is obvious that family partnerships which could qualify under the bill would usually enjoy distinct tax advantages over family owned corporations.

VIII. Illustrative Example

A. *Assumptions*

For comparative purposes, the same assumptions are made as in Paragraph VI, A above, except that the hypothetical family partnership is treated as valid for tax purposes under the proposed Revenue Bill of 1948, which is assumed to have been enacted in its present form.

B. *Federal Income Taxes under Corporation*

(As under Paragraph VI, C above)

Corporation Tax	$30,400
Husband's and Wife's Tax	25,584
Son's Tax	4,314
Combined Taxes under Corporation	$60,298

C. *Federal Income Taxes under Family Partnership*

Partnership Net Income	$100,000
Less Husband's "salary"	-20,000
Remainder of Net Income	$80,000

Husband's and Wife's Tax Status

Husband's "Salary"	$20,000	
Husband's Share (40%)	32,000	
Husband's Other Income	20,000	
Wife's Share (30%)	24,000	
Combined Net Taxable Incomes	$96,000	
(One-half of $96,000)	$48,000	
Tax on $48,000	$22,314	
Husband's and Wife's Tax (Twice $22,314)		$44,628

Son's Tax Status

Son's Share of Partnership Net Income (30%)	$24,000	
Son's Other Income	5,000	
Son's Net Taxable Income	$29,000	
Son's Tax		11,068
Combined Taxes under Partnership		$55,696

D. *Summary*

Combined Income Taxes under Corporation	$60,298
Combined Income Taxes under Partnership	55,696
Tax Saving under Partnership	$4,602

IX. Conclusion

Family partnerships should enjoy marked popularity under the Revenue Revision Bill of 1948, if enacted in its present form, because, in many cases, they will be distinctly preferable to corporations from the tax standpoint. Valid family partnerships would have the full benefit of the division of income now obtainable through corporations. While it is true that partnerships would still not have the advantages of accumulation of income and of deferred payment of income taxes, these corporate advantages would often be more than offset by the partnership's freedom from corporation taxes.

In considering any change from the corporate to the partnership form, it must be borne in mind that the liquidation of the corporation would result in capital gain taxes to the stockholders upon any excess in value of the net assets distributed in liquidation over the cost basis of the stock in their hands. [19] Under present law these taxes would usually be at the rate of 25% of any such gain, assuming that the stock had been held for more than six months.[20]

However, such capital gain taxes might actually be a source of substantial tax savings over a period of years. For example, if the inventory, plant, or machinery had increased in value over its cost basis for tax purposes in the hands of the corporation, such increased value would be the cost basis of such property upon any subsequent sale by the partnership, thus eliminating the ordinary taxable income or capital gain which would otherwise be realized upon such sale. In the case of the plant or machinery, a similar "stepped-up" basis would also be obtained for purposes of depre-

19. INT. REV. CODE § 115(c).

20. INT. REV. CODE §§ 117(a)(4), 117(b), 117(c).

ciation. This would provide greater annual depreciation deductions over the remaining life of the property, which would also offset ordinary taxable income. Moreover, any such increase in cost basis would save tax to the partners at their highest individual surtax rates, while a long-term capital gain upon liquidation of the corporation would have been taxed at only 25%.

A possible future development, not yet seriously considered, might well prove to be the controlling factor in choosing between a family partnership and a closely held corporation. If the present tense international situation should become even more critical, a new excess profits tax might well be imposed upon corporations to support a vastly enlarged rearmament program. While the effect of this would undoubtedly be partly offset by increases in individual surtax rates, the net result, under the Revenue Revision Bill, should be a sharp rise in the popularity of the family partnership, just as during the war years.

Finally, it seems hardly necessary to add that ordinarily no action should be taken in furtherance of a proposed change in the form of organization of a family controlled business until the Revenue Revision Bill has become law, since the Senate Finance Committee might present a bill of its own with quite dissimilar terms. In such event, it would not be surprising if the resulting conference to iron out the differences resulted in an act with less favorable provisions for the owners of a family controlled business.