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I

Introduction

THE usual type of family partnership[1] has the taxpayer operating or organizing a business, and giving or selling a portion of that business to his wife or children. The aim of the taxpayer is to divide his income among members of the family group.[2] The profits are thus taxed to two or more individuals, rather than to the taxpayer alone. Recognition of these family partnerships for federal income tax purposes is just one aspect of the family income problem.

Since the enactment of the income tax statute in 1913,[3] taxpayers have used many techniques in attempting to minimize taxes on income and still retain the benefits of its control.[4]

Assignments of income from personal services,[5] from the beneficial

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[1] The term family partnership will be used to denote a husband and wife partnership as well as a partnership of which children or other relatives of the taxpayer are members.

[2] Randolph Paul, "The Background of the Revenue Act of 1937," 5 Univ. Chi. L. Rev. 41 at 48 (1937). "One characteristic underlies several of these devices; the multiplication of the taxpayer's personality. A taxpayer . . . starts with single individuality and subdivides himself by various mechanisms into a group of people."

[3] Revenue Act of 1913, 38 Stat. L. 166.

[4] Mr. Justice Cardozo in Burnet v. Wells, 289 U.S. 670 at 676, 53 S.Ct. 761 (1933). "One can read in the revisions of the Revenue Acts the record of the government's endeavor to keep pace with the fertility of invention whereby the taxpayers had contrived to keep the larger benefits of ownership and be relieved of the attendant burdens."

[5] Lucas v. Earl, 281 U.S. 111, 50 S. Ct. 241 (1930). Here the assignor had services still to perform before the compensation was earned, and the Court held the assignor taxable on the portion assigned to the wife.

Cf. Helvering v. Eubank, 311 U.S. 122, 61 S.Ct. 149 (1940) where the taxpayer attempted assignment of renewal insurance commissions, and no further services were required of the assignor; *held*, taxable to the assignor.

Contra: Hall v. Burnet, (C.C.A. D.C. 1931) 54 F. (2d) 443, certiorari denied, 285 U.S. 552, 52 S.Ct. 407 (1932).

interest in a trust,[6] and from property,[7] have all been ineffective in shifting the tax burden.[8] Setting up trusts for members of the family[9] has also been a favorite method of dividing income, thus avoiding some of the effects of graduated rates.[10] From the use of all these devices the only concrete result has been a large volume of litigation and defeat after defeat for the taxpayer.[11]

"Through the devices thus neutralized, as well as through many others, there runs a common thread of purpose. The soli-

[6] Harrison v. Schaffner, 312 U.S. 579, 61 S.Ct. 759 (1941). The beneficiary of a trust assigned his interest to his wife for a term of one year. The income was taxed to the assignor.

But cf. Blair v. Commissioner, 300 U.S. 5, 57 S.Ct. 330 (1937). The beneficiary of a trust assigned irrevocably a portion of his interest. The assignment was for the duration of the trust. The Court held that the assignee became in effect a beneficiary of the trust and was taxable on its income.

[7] Helvering v. Horst, 311 U.S. 112, 61 S.Ct. 144 (1940). Gift before maturity of interest coupons from bonds. *Held*, taxable to donor.

Cf. Griffiths v. Helvering, 308 U.S. 355, 60 S.Ct. 277 (1939). The taxpayer attempted to consummate a sale of shares through the medium of a wholly owned corporation. The corporate entity was disregarded and the income taxed to the assignor.

[8] Community property has been a conspicious exception to the general rule stated in the text. The validity of the community property device in splitting income for tax purposes between husband and wife was upheld for the eight traditional community property states in Poe v. Seaborn, 282 U.S. 101, 51 S.Ct. 58 (1930).

Recent attempts to extend the benefits of this decision to Oklahoma families were scotched by the Supreme Court in Commissioner v. Harmon, 323 U.S. 44, 65 S.Ct. 103 (1944).

[9] The income from a trust revocable by the settlor was taxed to the settlor under the Revenue Act of 1924, 43 Stat. L. 253 at 277, in Corliss v. Bowers, 281 U.S. 376, 50 S.Ct. 336 (1930); the same result was reached under the same statute when the trust was revocable by the settlor and a person not having a "substantial adverse interest" in Reineke v. Smith, 289 U.S. 172, S.Ct. 570 (1933).

Funded insurance trusts for insurance on the life of the grantor in Burnet v. Wells, 289 U.S. 670, 53 S.Ct. 761 (1933).

Alimony trusts and trusts to discharge an obligation of the settlor held taxable to the settlor in Douglas v. Willcuts, 296 U.S. 1, 56 S.Ct. 59 (1935). (Changed as to alimony trusts by the Revenue Act of 1942, § 200; now § 171 of the I.R.C.)

The same result was reached in Helvering v. Schweitzer, 296 U.S. 551, 56 S.Ct. 304 (1935), on trusts for support of minor children.

Helvering v. Clifford, 309 U.S. 331, 60 S.Ct. 554 (1940), taxed the income from a term trust to the settlor.

Helvering v. Stuart, 317 U.S. 154, 63 S.Ct. 140 (1942), taxed entire income of a trust for minor children to the settlor-father. But cf. § 134 of the Revenue Act of 1943.

[10] Burnet v. Wells, 289 U.S. 670 at 675, 53 S.Ct. 761 (1933).

[11] The cases cited in notes 5, 6, 7, and 9, supra, are not intended to serve as a list of authorities on the problems therein discussed. They are cited to delineate some other aspects of the family income problem.

> darity of the family is to make it possible for the taxpayer to surrender title to another and to keep dominion for himself, or, if not technical dominion, at least the substance of enjoyment."[12]

In essence, this retention of 'the substance of enjoyment' is the motive for the creation of most present day family partnerships.

Family partnerships have as yet had little attention from the United States Supreme Court.[13] This is probably due to the secondary role which partnerships have had as a method of business organization.[14] The corporate form of organization has the advantages of limiting liability to the amount of capital invested and continuing in operation after the death or personal insolvency of its owners.[15] So, despite the excess profits tax which has caused a great many closely held corporations to be liquidated and replaced by partnerships, it is unlikely that the partnership will replace the corporation as the organizational form for larger business enterprises. But for smaller businesses depending upon the abilities of a few men for their success, a partnership which will avoid the corporate income and excess profits taxes is a desirable form of business organization.

Partnerships are dealt with in subtitle A, chapter 1, subchapter C, supplement F of the Internal Revenue Code. Section 181[16] provides that partnerships, as such, are not taxable, and that the partners are to be taxed only in their individual capacity. Section 187 requires the filing of partnership information returns. The statute here presents a basic dichotomy; we recognize the partnership entity for the purpose of filing returns, and look through it to tax the partners.

The term "partnership" is defined in section 3797 (a) (2) of the Internal Revenue Code. It is not a very satisfactory definition. For, though the code provides that other types of business organizations are to be taxed as partnerships, it does not define, for income tax purposes, the essential elements of a partnership. One might expect to

[12] Mr. Justice Cardozo in Burnet v. Wells, 289 U.S. 670 at 677, 53 S.Ct. 761 (1933).

[13] Burnet v. Leininger, 285 U.S. 136, 52 S.Ct. 345 (1932), did involve a situation similar to a family partnership. It was not an attempt at a true family partnership as the taxpayer did not attempt to make his wife a partner in the partnership enterprise. The case is more fully discussed in section II of the text, infra.

[14] Rabkin and Johnson, "The Partnership Under the Federal Tax Laws," 55 HARV. L. REV. 909 (1942).

[15] Id. at 910.

[16] This section is still substantially the same as c. 16, § III, D, of the Revenue Act of 1913, 38 Stat. L. 168.

rely upon the common law definitions as to what constitutes a partnership and who are partners,[17] but the Regulations[18] are a warning against any such reliance upon local law. So we may have a business organization which is a valid partnership by state law, and is not recognized as such for income tax purposes;[19] and conversely, though not recognized by local law it may be a valid partnership under the Internal Revenue Code.[20]

II

TESTS TO DETERMINE THE INCIDENCE OF FEDERAL INCOME TAX BEFORE 1930—VALIDITY OF PARTNERSHIP UNDER STATE LAW

A. *Test of Validity of Common Law Partnership: Meehan v. Valentine*

When the problem of family partnerships first came before the courts and the Board of Tax Appeals, state law and common law property concepts were used to determine whether or not a partnership existed. The decisions which did not allow the wife and children to share income were based on the theory that the wife or children were not members of the partnership.[21] If under the applicable state law it was a valid partnership, it would be recognized for income tax purposes. Using state law to determine the incidence of the federal income tax led to different results in similar situations.[22] *Meehan v. Valentine*[23] is a general statement of the common law prerequisites of

[17] 6 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 35.02, note 10. " . . . statute does not attempt, however, an all inclusive definition and accordingly it would seem local law and common law would be factors to be considered in determining whether organizations other than those set forth in the statute should be treated as partnerships for purposes of taxation, and as to who are partners generally."

[18] TREAS. REG. 111, § 29.3797-1 provides that the I.R.C. makes its own classification for purposes of taxation and that local law is of no importance in this connection. See also TREAS. REG. 111, § 29.3797-4.

[19] TREAS. REG. 111, § 29.3797-1. The entire income of the partnership may be taxed to one of the partners, e.g., M.M.Argo, 3 T.C. 1120 (1944), or it may be taxed as a corporation, TREAS. REG. 111, §§ 29.3797-4, 5.

[20] Pugh v. United States, (D.C. W. Va. 1931) 48 F. (2d) 600; J. W. Brackman, 24 B.T.A. 259 (1931); J. E. Biggs, Sr., 15 B.T.A. 1092 (1929); Albert Kahn, 14 B.T.A. 125 (1928); Elmer Klise, 10 B.T.A. 1234 (1928); Earle L. Crossman, 10 B.T.A. 248 (1928); L. F. Sunlin, 6 B.T.A. 1232 (1927); many other cases could be cited to the same effect.

[21] Randolph Paul, "The Background of the Revenue Act of 1937," 5 UNIV. CHI. L. REV. 41 at 76 (1937).

[22] Compare Hudson M. Knapp, 5 B.T.A. 762 (1926), with Harry P. Kelly, 9 B.T.A. 832 (1927).

[23] 145 U.S. 611, 12 S.Ct. 972 (1892).

a valid partnership. It set up three requirements which are still considered essential:[24] (1) that the parties join together to carry on a trade for the common benefit, (2) each party contribute property or services, and (3) the parties have a community of interest in the profits.

B. *Contribution of Capital or Service to Partnership as Test of Validity*

In *Nancy J. Ryman*[25] the decedent taxpayer went into the cattle business with his sons, and the taxpayer and his sons each contributed capital and services and shared profits. The board found a common law partnership valid for income tax purposes.

When the taxpayer's wife was his partner, each contributing capital and services, and the applicable state law allowed the wife to become her husband's partner, the family partnership was also recognized.[26]

And when the father contributed property with the understanding that the children were to work in the business and the profits were to be divided,[27] the Board of Tax Appeals found that a valid partnership existed. This result could hardly be challenged today, since the children actually managed the business.

If each partner contributes capital and services, (or one partner capital and the other services) the partnership should be recognized, for it has met the requirements of *Meehan v. Valentine*, and a common law partnership has been formed.

The fact that state law does not forbid family partnerships is not reason enough to hold a partnership valid. This became more apparent when family partnerships appeared in which the wife did not contribute services, and her contribution of capital was limited to what had previously been received as a gift from her husband-partner.[28]

[24] E.g., Felix Zukaitis, 3 T.C. 814 (1944); Frank J. Lorenz, 3 T.C. 746 (1944).

[25] 5 B.T.A. 1288 (1927).

[26] H. J. Bartron, 3 B.T.A. 1262 (1926); Thomas F. Kelly, 9 B.T.A. 834 (1927); R. C. McKnight, 13 B.T.A. 885 (1928). Failure to file partnership information returns in the Bartron and McKnight cases, supra, was not thought to require a different result.

[27] Frank E. Eyestone, 12 B.T.A. 1232 (1928); H. T. Loper, 12 B.T.A. 164 (1928). Cf. John Peters, 16 B.T.A. 895 (1929).

[28] Estate of John Barnes, Jr., 7 B.T.A. 924 (1927), affirmed sub nom., Commissioner v. Barnes, (C.C.A. 3d, 1929) 30 F. (2d) 289; W. A. Bellingrath, 3 B.T.A. 11 (1925); M.L. Virden, 6 B.T.A. 1123 (1927); John T. Newell, 17 B.T.A. 93 (1929).

Accord: Warren MacPherson, 19 B.T.A. 651 (1930), where the capital was a gift of the wife's father-in-law.

The partnerships were held valid on the grounds that state law permitted husband and wife partnerships and there was sufficient evidence of an intent to form a partnership. This result was reached though the parties did not comply with all the formalities of state law,[29] the other partners not having been notified of the admission of a new partner, and by the applicable state law the wife just got a right to the profits.[30]

In *L. S. Cobb*[31] the wife's capital contribution to the partnership was a gift from her husband. The gift was conditional; a divorce would terminate the wife's interest in the partnership. The Board of Tax Appeals considered this condition subsequent void as "repugnant to the interest created," and held that a valid partnership was formed under California law.

The same result was reached though the wife's share of the profits was a fixed sum, the business was carried on in the name of the husband, no one knew of the partnership, and no partnership returns were filed.[32]

In *J. E. Biggs, Sr.*[33] the West Virginia law did not permit a husband and wife partnership. The board held that such a partnership agreement was enforceable in equity if fair to the wife. The partnership was unheld despite the failure of the wife to contribute any capital. Capital to start the coal business was obtained through a loan secured by a note which the wife did not sign.

The results were much the same when children were the challenged members of the family partnership. When the taxpayer set up a trust for a minor child and then entered into partnership with the trust and the profits were paid to the trust,[34] the partnership was recognized. Where the taxpayer assigned his interest in a partnership to his seven children, the profits were held taxable to the children.[35] In neither of the cases did the children render services to the partnership,

[29] John T. Newell, 17 B.T.A. 93 (1929). Cf. William W. Parshall, 7 B.T.A. 318 (1927), acquiescence, B.T.A. 6452, INT. REV. BUL. 24 (1928).

[30] Estate of John Barnes, Jr., 7 B.T.A. 924 (1927), affirmed sub nom., Commissioner v. Barnes, (C.C.A. 3d, 1929) 30 F. (2d) 289.

[31] 9 B.T.A. 547 (1927). No services were performed by the wife. The result is extremely doubtful even on local law since the wife had no right to her share of the profits unless a majority of the other partners agreed to give them to her.

[32] R. A. Bartley, 4 B.T.A. 874 (1926).

[33] 15 B.T.A. 1092 (1929).

[34] M. A. Reeb, 8 B.T.A. 759 (1927).

[35] John Peters, 16 B.T.A. 895 (1929). Cf. Harry P. Kelly, 9 B.T.A. 832 (1927).

and their capital contributions were limited to amounts received as gifts from their father.

In *Millard D. Olds*[36] the taxpayer wanted to make his three daughters his partners. He decided to sell each of them a 25 percent interest in his business, taking a $400,000 demand note, non-interest bearing, as payment from each. The father was to continue to conduct the business in his own name, and the daughters were not to withdraw any of the profits except as he saw fit. Then the father obtained a Michigan court decree calling the arrangement a valid partnership. The daughters had the privilege of rescinding the transaction. The Court for the Sixth Circuit called it a valid partnership, saying that it was not material that the taxpayer could decide how much his daughters could withdraw: this was a collateral agreement within the power of the partners. Nor did the court think it material that the taxpayer would not collect on the notes.

> "They [the notes] were executed and were collectible in his hands except upon a good faith showing of dissatisfaction. Besides, he had the right to give an interest in his business to his daughters. There is no creditor attacking the transaction, and if the gift was made in good faith, the taxing authorities can not complain."[37]

When there was no substantial evidence of more than an intent of the parties to form a partnership, the Board of Tax Appeals had no difficulty in holding that the arrangement was not a partnership for tax purposes,[38] although making no mention of the fact that any income of the business was entirely from the personal services of the husband. So when other personal service arrangements, in which the parties had gone through the form of creating a partnership organization, came before the board, they were held valid.[39] The result is not surprising, for throughout this period many of the board's decisions seem to intimate that the recipient of income is the party to be taxed.[40]

[36] Millard D. Olds, 15 B.T.A. 560 (1929), affirmed, (C.C.A. 6th, 1932) 60 F. (2d) 252.

[37] 60 F. (2d) 252 at 255 (1932).

[38] W. A. Felton, 18 B.T.A. 63 (1929). Cf. Julius Goldenberg, 5 B.T.A. 213 (1926), where even an intent to form a partnership seems doubtful.

[39] Elihu Clement Wilson, 11 B.T.A. 963 (1928), non-acquiescence, B.T.A. 8500, 8 INT. REV. BUL. 62 (1929); C. W. Crane, 19 B.T.A. 577 (1930).

[40] A. T. Wagner,17 B.T.A. 1030 (1929); R. E. Wing, 17 B.T.A. 1028 (1929); Commissioner v. Barnes, (C.C.A. 3d, 1929) 30 F. (2d) 289.

C. *Transfer of Present Interest in Firm Assets as Requirement for Validity*

Where the parents attempted to enter into a partnership agreement with their son to give him a share of the profits without giving a present interest in the firm assets, this was held to be the equivalent of an assignment of income and taxable to the parents since the son contributed neither capital nor services.[41] There was, however, a dissent which stated that a partnership is a contractural relationship, contributions of capital or services are not necessary, and that if the parties agree to be partners, outsiders cannot challenge the agreement.[42]

D. *Effect of Invalidity of Husband and Wife Partnerships Under State Law*

The Board of Tax Appeals found it difficult to apply its local law characterization consistently. Partnerships which were otherwise valid because of a contribution by both husband and wife of capital and services came before the board from states which did not allow a wife to be her husband's partner.

In *L. F. Sunlin*[43] it was held that the purpose of the Michigan statute forbidding husband and wife partnerships was to enlarge the rights of the wife, not to deprive her of her property, and that the wife did not lose her interest in the business because of her marriage.

Cf. W. A. Bellingrath, 3 B.T.A. 11 (1925); R. A. Bartley, 4 B.T.A. 874 (1926).

[41] John W. Graham, 8 B.T.A. 1081 (1927); Samuel J. Lidov, 16 B.T.A. 1421 (1929).

Cf. Meyers v. Allen, (C.C.A. 8th, 1929) 34 F. (2d) 883; Charles F. Colbert, Jr., 12 B.T.A. 565 (1928).

[42] Harry P. Kelly, 9 B.T.A. 832 (1927).

Cf. John Peters, 16 B.T.A. 895 (1929), where crediting of profits was held to give an interest in the business.

[43] 6 B.T.A. 1232 (1927).

Cf. Earle L. Crossman, 10 B.T.A. 248 (1928); Elmer Klise, 10 B.T.A. 1234 (1928), where wife contributed capital only; Albert Kahn, 14 B.T.A. 125 (1928), where wife contributed capital and neither husband nor wife contributed services; Pugh v. United States, (D.C. W. Va. 1931) 48 F. (2d) 600; and Arthur Stryker, 17 B.T.A. 1033 (1929), where wife contributed services and property acquired by gift; J. W. Brackman, 24 B.T.A. 259 (1931), wife contributing services. All the above cases held wife taxable on her share.

But see Hamilton v. Commissioner, (C.C.A. 1st, 1928) 24 F. (2d) 668, where wife contributed capital and husband the services and *held*, no partnership because Massachusetts law does not allow husband and wife to be partners.

This holding was based upon the policy of the local law, rather than upon its letter; but it was a significant step in the direction of developing independent characterization for the revenue laws and imposing a uniform tax burden upon similar business arrangements in whatever state made.

In this period before 1930, the general technique of analysis of the validity of the family partnership seems to have been that if the parties to the challenged partnership were satsified, the tax collector could not complain.[44] The courts and the Board of Tax Appeals lost sight of the fact that *Meehan v. Valentine*, required the parties to associate, or join together, to carry on a trade for the common benefit. In this period it mattered not that the partnership was a personal service partnership,[45] or that the challenged member of the partnership contributed no capital.[46] So long as the parties went through the formal ritual of creating a partnership, it was generally held valid.

III

THE SUB-PARTNERSHIP: BURNET V. LEININGER

A situation similar to a family partnership is presented when the taxpayer is conducting a partnership business with a third party and gives to his wife or children a share of his interest. The taxpayer makes no attempt to give a present interest in the firm assets. *Burnet v. Leininger*[47] is the leading case on this sub-partnership variation of the family income problem.

In *Burnet v. Leininger* the taxpayer and his wife agree to share the profit and loss from the taxpayer's interest in a partnership. The other partner did not consent to the wife becoming a partner in the firm; the wife did not contribute capital or services. The profits were paid to the taxpayer who in turn paid them to his wife. The Court held that

[44] Commissioner v. Olds, 15 B.T.A. 560 (1929), affirmed, (C.C.A. 6th, 1932) 60 F. (2d) 252; B. M. Phelps, 13 B.T.A. 1248 (1928).

See John W. Graham, 8 B.T.A. 1081 at 1085 (1927) (dissenting opinion).

Perhaps the highpoint of this view was reached in E. L. Kier, 15 B.T.A. 1114 (1929). Love, member of the Board of Tax Appeals, thought so highly of the arrangement there under review that he could not restrain himself from penning an ode to the petitioners. He said, 15 B.T.A. at 1118, "This was a family business. There existed between the brothers a harmony and affection that is refreshing to note and in the marital communities an admirable spirit of cooperation . . . . We believe no reasonable element of suspicion can be drawn from the informalities . . . ."

[45] See note 39, supra.

[46] See note 33, supra.

[47] 285 U.S. 136, 52 S.Ct. 345 (1932).

the husband was taxable on the profits, since the wife's interest was purely derivative, and an agreement to share profits and loss is not enough to constitute the wife a member of the partnership.

As long as there was no gift of a present interest in the firm assets, the Board of Tax Appeals and the circuit courts had no difficulty in reaching the same results,[48] and the *Leininger* decision affirmed their handling of the problem.

There is little essential difference between a sub-partnership and an assignment of income. There are three important events in the taxation of income: earning, receipt, and enjoyment.[49] In *Lucas c. Earl*[50] the revenue acts were construed to tax income to him who earned it, despite any anticipatory arrangement designed to prevent its vesting in the earner. The assignor remains in control of the income, for it is only through his continued efforts that the income could be earned.[51] Control of the disposition of income by the earner is a substantial equivalent of its receipt and enjoyment, and makes it taxable to the earner.[52]

At common law a partnership is not considered a juristic entity,[53] and the revenue acts have taxed the individual partners and ignored the firm.[54] If we look through the partnership entity to the partner who is liable for the tax, *Burnet v. Leininger* is a necessary corollary of *Lucas v. Earl.* Since no attempt is made to give a present interest in the firm assets, the property and services of the assignor-partner produce the income, and any assignment of earnings, conditional upon his continued efforts, is subject to his control.

[48] George M. Cohan, 11 B.T.A. 743 (1928), affirmed, (C.C.A. 2d, 1930) 39 F. (2d) 540; Sam H. Harris, 11 B.T.A. 871 (1928), affirmed, (C.C.A. 2d, 1930) 39 F. (2d) 546; Luce v. Burnet, (C.C.A.D.C. 1932) 55 F. (2d) 751, affirming, 18 B.T.A. 923 (1930); J. Fred Staebler, 17 B.T.A. 1086 (1929); W. L. Heinickle, 20 B.T.A. 155 (1930); Houston Brothers, 22 B.T.A. 51 (1931); E. W. Battleson, 22 B.T.A. 455 (1931).

Cf. T. V. Larsen, 14 B.T.A. 160 (1928), affirmed, (C.C.A.D.C. 1930) 50 F. (2d) 308.

But see C. R. Thomas, 8 B.T.A. 118 (1927), where the profits were taxed to the recipient who had purchased a share of her father's interest with her own money. The Board of Tax Appeals found a trust in favor of the daughter, and *held*, amount distributed to the daughter could be deducted from gross income of the trust.

[49] Van Meter v. Commissioner, (C.C.A. 8th, 1932) 61 F. (2d) 817.

[50] 281 U.S. 111, 50 S.Ct. 241 (1930).

[51] Rossmoore v. Commissioner, (C.C.A. 2d, 1935) 76 F. (2d) 520.

[52] Corliss v. Bowers, 281 U.S. 376, 50 S.Ct. 336 (1930).

[53] Rossmoore v. Commissioner, (C.C.A. 2d, 1935) 76 F. (2d) 520.

[54] I.R.C., § 181.

IV

EFFECT OF THE DOCTRINE OF LUCAS v. EARL ON FAMILY PARTNERSHIPS

The decision in *Lucas v. Earl*, did not have as great an effect on the lower federal courts and the Board of Tax Appeals as its language might suggest. The requirement that "import and reasonable construction" of the taxing statutes, rather than "attenuated subleties," were to control was not too closely followed during the years immediately after the decision.

Local laws were still, in some cases, the basis of decisions favorable to the taxpayer.[55] Receipt of profits was held prima facie evidence of partnership by local law, and the fact that no interest in the firm assets was granted to the challenged partners was held not to upset the prima facie case.[56] Nor did use by the wife of partnership profits to pay household expenses, which had formerly been paid by the taxpayer, seem to invalidate the arrangement.[57]

The cases reiterated that a husband had the right to give his wife or children a share of his business if he saw fit to do so,[58] and if a gift were made, the family partnership was valid for tax purposes.[59] The gift was held valid though the taxpayer remained the owner of the interest on the books of the partnership, and the profits were paid to him rather than to his donees; and he continued to make capital contributions to the partnership, retained management of the partnership, and retained his responsibility to the other partners.[60]

Nor did the taxpayer's reservation of sole authority to run the business seem to invalidate the gift.[61] Even taking all the profits (with the consent of the taxpayer's two minor children) and giving a note as security (two years later) was not thought to be so incompatible

[55] D. M. Rose, Administrator, 22 B.T.A. 1334 (1931), reversed sub nom., Rose v. Commissioner, (C.C.A. 6th, 1933) 65 F. (2d) 616; W. H. Simmons, 22 B.T.A. 1106 (1931); N. H. Hazlewood, 29 B.T.A. 595 (1933).

[56] W. H. Simmons, 22 B.T.A. 1106 (1931).

[57] Rose v. Commissioner, (C.C.A. 6th, 1933) 65 F. (2d) 616; Glenn M. Harrington, 21 B.T.A. 260 (1930).

[58] Rose v. Commissioner, (C.C.A. 6th, 1933) 65 F. (2d) 616.

[59] Lula Kell, 32 B.T.A. 21 (1935), reversed sub nom., Kell v. Commissioner, (C.C.A. 5th, 1937) 88 F. (2d) 453; Pugh v. United States, (D.C.W.Va. 1931) 48 F. (2d) 600; Walter W. Moyer, 35 B.T.A. 1155 (1937); N. H. Hazlewood, 29 B.T.A. 595 (1933); Richard H. Oakley, 24 B.T.A. 1082 (1931); Albert G. Dickinson, 23 B.T.A. 1212 (1931).

[60] Kell v. Commissioner, (C.C.A. 5th, 1937) 88 F. (2d) 453.

[61] Richard H. Oakley, 24 B.T.A. 1082 (1931).

with an irrevocable gift as to make the partnership profits taxable to the donor. The Board of Tax Appeals refused to question the bona fides of the transaction.[62] A motive of tax avoidance in making the gift did not in itself make the partnership invalid for tax purposes.[63]

An oral agreement to form a partnership was held just as effective as a written one,[64] and the fact that the business was conducted in the name of only one of the partners was not thought to be conclusive evidence against the formation of a valid partnership.[65]

However, the eight years following *Lucas v. Earl* were marked by some significant changes in the handling of family partnerships. The theory that a personal service partnership would not be recognized when the alleged partner contributed no services was effectively established during this period. Local law was toppled from its position of pre-eminence in characterization of the tax laws, and the judges began to realize that family arrangements which resulted in substantial tax benefits ought to be closely scrutinized.

A. *Evidence Required to Establish Partnership*

Rather than accepting the taxpayer's mere self-serving statements, the Board of Tax Appeals and the courts began to require credible evidence of conduct demonstrating the alleged partner's actual participation in the business and an assumption of responsibilities to those with whom the business is transacted.[66]

Merely permitting wife and children to draw checks on the partnership account,[67] was not considered credible evidence of the establishment of a partnership; nor was the reservation of the right to deprive the alleged partner of any share of the profits thought compatible with a valid family partnership.[68]

[62] N. H. Hazlewood, 29 B.T.A. 595 (1933).
Cf. Kell v. Commissioner, (C.C.A. 5th, 1937) 88 F. (2d) 453.

[63] Walter W. Moyer, 35 B.T.A. 1155 (1937).

[64] Champlin v. Commissioner, (C.C.A. 10th, 1934) 71 F. (2d) 23; Charles Tifft, 25 B.T.A. 986 (1932); J. Kammerdiner, 25 B.T.A. 495 (1932); Albert G. Dickinson, 23 B.T.A. 1212 (1931); Leonard M. Gunderson, 23 B.T.A. 45 (1931).
But see Glenn M. Harrington, 21 B.T.A. 260 (1930); J. Howard Coombs, 20 B.T.A. 1021 (1930), and its sequel, Elizabeth M. Coombs, 25 B.T.A. 1320 (1932).

[65] Champlin v. Commissioner, (C.C.A. 10th, 1934) 71 F. (2d) 23; Walter W. Moyer, 35 B.T.A. 1155 (1937); J. Kammerdiner, 25 B.T.A. 495 (1932); Leonard M. Gunderson, 23 B.T.A. 45 (1931).

[66] Estate of E. A. Wickham, 22 B.T.A. 1393 (1931), affirmed sub nom., Wickham v. Commissioner, (C.C.A. 8th, 1933) 65 F. (2d) 527; W. M. Buchanan, 20 B.T.A. 210 (1930).

[67] Covington v. Commissioner, (C.C.A. 5th, 1939) 103 F. (2d) 201.

[68] T. L. Tally, 22 B.T.A. 712 (1931).

Nor was an agreement to share profit and loss held to have the same effect in a tax case as in a suit to establish a partnership over the opposition of one of the members. The suit against a partner would establish liability as well as the right to share profits. In a suit by the government the only effect of such an agreement is to give an additional tax advantage.[69]

When the taxpayer introduced his wife or children as partners to his business associates, credit agencies, banks, or creditors this holding out was considered credible evidence of a partnership,[70] especially if the wife or children had separate property which would add to the credit of the firm.[71]

This requirement of credible evidence of a partnership to support self-serving statements was a drastic departure from the view that if the parties to the agreement were satisfied, the government had no standing to complain.[72]

B. *Waning Influence of Local Law*

During the decade following *Lucas v. Earl* the local law became less important in determining who are partners and in setting up the requirements for a valid partnership. Local partnership law is designed to safeguard the rights of partner against partner, and the rights of creditors against the partnership. The United States, in imposing an income tax, occupies neither the position of partner nor of creditor so there is no reason why the local property characterization should be binding on either the government or the taxpayer.

In tax cases the tests established by local law impose no liabilities;[73] they merely give the parties a tax advantage.[74] When this became apparent, the courts began to hold that when Congress has shown how a tax is to be imposed, they were not going to let state law make a difference.[75] Even when state law was invoked, it was to determine the validity of a transfer of property rights, not to deter-

[69] Covington v. Commissioner, (C.C.A. 5th, 1939) 103 F. (2d) 201; James L. Robertson, 20 B.T.A. 112 (1930); W. M. Buchanan, 20 B.T.A. 210 (1930); Harry C. Fisher, 29 B.T.A. 1041 (1934).

[70] Pugh v. United States, (D.C.W.Va. 1931) 48 F. (2d) 600; Leonard M. Gunderson, 23 B.T.A. 45 (1931); Albert G. Dickinson, 23 B.T.A. 1212 (1931); J. Kammerdiner, 25 B.T.A. 495 (1932).

[71] Pugh v. United States, (D.C.W.Va. 1931) 48 F. (2d) 600.

[72] See note 44, supra.

[73] James L. Robertson, 20 B.T.A. 112 (1930).

[74] William M. Buchanan, 20 B.T.A. 210 (1930).

[75] Glenn M. Harrington, 21 B.T.A. 260 (1930); Elizabeth M. Coombs, 25 B.T.A. 1320 (1932).

mine the litigants' status as partners.[76] Local law was no longer important in determining who were partners under section 181 of the Internal Revenue Code.[77]

C. *Personal Service Partnership*

During this period the problem of the personal service family partnership was presented to the courts. The personal service partnership is one in which capital is not a material income producing factor. The earnings of the firm are dependent upon the talents and abilities of the partners, and not upon the amount of capital invested in the enterprise. In effect, the true capital asset of the firm is the personal ability of the partners. If we look through the partnership entity to the individual partner, all the earnings of the partnership are income from the personal services of the firm members; and any attempt to divide those earnings with a partner who does not contribute services is essentially an assignment of income and should not be recognized for income tax purposes.

The courts did not analzye the problem in these terms. No distinction was made between a partnership conducting a business in which capital was a material income producing factor, and a partnership in which services were of paramount importance. So we find a personal service partnership being declared invalid because the taxpayer did not relinquish control of the profits, and remained essentially the owner of them.[78] In other cases the analysis was in terms of close scrutiny of conduct being required in any family arrangement and the conduct belying a partnership.[79] At other times we get hints that the personal service aspects of the partnership under review is the basis for the decision when it is stated that the challenged partners did not have such relation to the business as to be considered partners.[80] But nowhere is there a clear statement of the theory underlying the decisions.

In the absence of a clear delineation of the theory involved, it is not surprising to find a personal service partnership recognized when all the formal requirements of a partnership were met, although neither capital nor services were contributed by the alleged partners.[81]

[76] Cf. Rose v. Commissioner, (C.C.A. 6th, 1933) 65 F. (2d) 616.

[77] Atwood v. United States, (D.C. Mich. 1932) 3 F. Supp. 321; Charles Tifft, 25 B.T.A. 986 (1932).

[78] Kasch v. Commissioner, (C.C.A. 5th, 1933) 63 F. (2d) 466, certiorari denied, 290 U.S. 644, 54 S.Ct. 62 (1933).

[79] Harry C. Fisher, 29 B.T.A. 1041 (1934); Thomas M. McIntyre, 37 B.T.A. 812 (1938).

[80] James L. Robertson, 20 B.T.A. 112 at 114 (1930).

[81] Clara B. Parker, Executrix, 30 B.T.A. 1231 (1934); Jasper Sipes, 31 B.T.A. 709 (1934).

A variation of the personal service partnership is found when capital is necessary to the successful conduct of the business, although personal services are the vital elements. In such a situation, when the wives of the taxpayers contributed the necessary capital, the family partnership was recognized for tax purposes.[82]

V

FEDERAL TAXATION SINCE HELVERING V. CLIFFORD

A. *The Doctrine of Helvering v. Clifford*

The decision in *Helvering v. Clifford*[83] marks a new era in federal taxation. The Commissioner of Internal Revenue and the Department of Justice had sought to persuade the courts to disregard artificial arrangements designed to evade taxes and to decide cases upon the economic realities underlying the transaction.[84] The *Clifford* decision was the culmination of these efforts.[85] Retention of control over property or enjoyment of indirect or insubstantial benefits which "blend so imperceptibly with the normal concepts of full ownership"[86] was now enough to determine the incidence of the tax.

Commissioner v. Tenney[87] is an example of the type of artificial partnership arrangements which were disposed of by the courts with little ceremony. There the wife contributed capital to be used by her husband in trading on the stock market. The capital was to remain the property of the wife; the husband was to give advice and the profits and losses were to be shared equally. The wife retained control over the sale and purchase of the shares, and the shares and brokerage account were listed in her name. Any profits resulted from the sale of property owned by the wife, and she was held taxable on the income.

B. *Personal Service Family Partnerships*

The personal service family partnership has come before the courts in many aspects since 1940. Constant exposure to this tax avoid-

[82] Humphreys v. Commissioner, (C.C.A. 2d, 1937) 88 F. (2d) 430; Charles Tifft, 25 B.T.A. 986 (1932).

[83] 309 U.S. 331, 60 S.Ct. 554 (1940).

[84] REP. ATTY. GEN. 66 (1937).

[85] This decision was foreshadowed by other cases which looked through the formal arrangements to the economic reality. Cf. Griffiths v. Commissioner, 308 U.S. 355, 60 S.Ct. 277 (1939); Higgins v. Smith, 308 U.S. 473, 60 S.Ct. 355 (1940); Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266 (1935); Robert S. Eaton, 37 B.T.A. 283 (1938), affirmed on opinion below, (C.C.A. 2d, 1939) 100 F. (2d) 1013, certiorari denied, 307 U.S. 636, 59 S.Ct. 1032 (1939).

[86] 309 U.S. 331 at 336, 60 S.Ct. 554 (1940).

[87] (C.C.A. 1st, 1941) 120 F. (2d) 421. Cf. Robert S. Eaton, 37 B.T.A. 283 (1938).

ance device has given the courts the opportunity to develop a logically consistent method of dealing with them.

There are many possible variations of the personal service family partnership. Probably the least subtle arrangement has the taxpayer and another member of his family agreeing to pool their earnings. The earnings are to go to a partnership and then to be divided equally between the partners.[88] The taxpayer may contribute a large amount of capital to the alleged partnership to give it an air of legitimacy.[89] It is difficult to call such an arrangement a partnership; it is an assignment of income and taxable to the earner of that income.[90]

When the taxpayer was a lawyer and attempted to form a partnership with members of his family, the partnership was not recognized.[91] For although a lawyer may form a partnership, any such agreement with his wife and child, neither of whom contributed services, is an assignment of earnings ineffective to shift the tax burden.

1. *Requirement of Contribution of Services*

Earp v. Jones[92] is the leading case on personal service partnerships. The taxpayer gave his wife an undivided one-half interest in his insurance business and went into partnership with her. Partnership books were set up and new contracts of agency were executed with the insurance companies.

The wife took no part in the conduct of the business. Household expenses formerly paid by the taxpayer were now charged to the wife's share of partnership earnings. The taxpayer went so far as to borrow the balance of her share of the profits and use them for his own purposes. It was found that the purpose of this arrangement was to minimize taxes, not to create a new enterprise. The Court for the Tenth Circuit held that when the taxpayer changes his method of doing business to minimize taxes, the changes must be real and substantial. The taxpayer here was still in complete control, still doing business in the same way without any of the real restrictions which usually flow from a partnership relation, and all the firm profits were taxable to him.[93]

[88] Villere v. Commissioner, (C.C.A. 5th, 1943) 133 F. (2d) 905; Joseph L. Sweigard, P-H (1944) MEMO. DEC. ¶44,351, 443 C.C.H. STANDARD FED. TAX SERV. ¶7813(M).

[89] Joseph L. Sweigard, P-H (1944) MEMO. DEC. ¶44,351, 443 C.C.H. STANDARD FED. TAX SERV. ¶7813(M).

[90] See note 88, supra.

[91] Tinkoff v. Commissioner, (C.C.A. 7th, 1941) 120 F. (2d) 564.

[92] (C.C.A. 10th, 1942) 131 F. (2d) 292, certiorari denied, 318 U.S. 764, 63 S.Ct. 665 (1943). See also Mead v. Commissioner, (C.C.A. 5th, 1942) 131 F. (2d) 323, similar facts and existence of family partnership again denied.

[93] Compare Peter B. Loftus, P-H (1944) MEMO. DEC. ¶44,307, 443 C.C.H.

It does not matter what the business of the taxpayer might be, so long as the earnings of that business are derived from the personal efforts of the individual, and not from any capital which may be employed in the firm. The taxpayer may be a salesman selling goods on commission,[94] the owner of an insurance agency,[95] or a repairer and rebuilder of machinery;[96] the principles involved are still the same. Although it may be an aid to the court in arriving at its decision, it is immaterial that the taxpayer had previously paid household expenses from his own earnings which are now being paid from the partnership earnings and charged against the distributive share of the wife.[97] Similarly, the disposition of profits is not material. That the wife did not withdraw her share of the profits,[98] or that the husband appropriated them to his own use[99] might be important in determining whether there was a partnership under the applicable state law in order to hold the wife liable to the firm's creditors, but it would be of no importance in determining tax liability.[100]

The salient fact remains that the taxpayer retains active manage-

STANDARD FED. TAX SERV. ¶7737(M) and E. R. Ledbetter, P-H (1942) MEMO. DEC. ¶42,039, 423 C.C.H. STANDARD FED. TAX SERV. ¶7401-G with Earp v. Jones, (C.C.A. 10th, 1942) 131 F. (2d) 292, certiorari denied.

In both Loftus and Ledbetter the partnership was recognized. The Tax Court found that capital was a material income producing factor and that the wife in each case contributed capital.

94 Waldburger v. Helvering, (C.C.A. 2d, 1942) 131 F. (2d) 598; Francis Doll, 2 T.C. 276 (1943), affirmed, (C.C.A. 8th, 1945) 149 F. (2d) 239; J. G. Fredeking, P-H (1943) MEMO. DEC. ¶43,464, 433 C.C.H. STANDARD FED. TAX SERV. ¶7754(M); G. Eliott Krusen, P-H (1944) MEMO. DEC. ¶44,287, 443 C.C.H. STANDARD FED. TAX SERV. ¶7714(M).

95 Mead v. Commissioner, (C.C.A. 5th, 1942) 131 F. (2d) 323; Earp v. Jones, (C.C.A. 10th, 1942) 131 F. (2d) 292, certiorari denied, 318 U.S. 764 (1943); Edward J. Miller, P-H (1944) MEMO. DEC. ¶44,083, 443 C.C.H. STANDARD FED. TAX SERV. ¶7414(M).

96 Schroder v. Commissioner, (C.C.A. 5th, 1943) 134 F. (2d) 346; M. M. Argo, 3 T.C. 1120 (1940).

97 Cf. Mead v. Commissioner, (C.C.A. 5th, 1942) 131 F. (2d) 323; Earp v. Jones, (C.C.A. 10th, 1942) 131 F. (2d) 292, certiorari denied, 318 U.S. 764 (1943); Waldburger v. Helvering, (C.C.A. 2d, 1942) 131 F. (2d) 598; M. M. Argo, 3 T.C., 1120 (1944); Edward J. Miller, P-H (1944) MEMO. DEC. ¶44,083, 443 C.C.H. STANDARD FED. TAX SERV. ¶7414(M); Leo J. Feistel, P-H (1945) MEMO. DEC. ¶45,035, 454 C.C.H. STANDARD FED. TAX SERV. ¶7269(M).

But cf. E. R. Ledbetter, P-H (1942) MEMO. DEC. ¶42,039, 423 C.C.H. STANDARD FED. TAX SERV. ¶7401-G, which recognized the partnership.

98 Waldburger v. Helvering, (C.C.A. 2d, 1942) 131 F. (2d) 598.

99 Mead v. Commissioner, (C.C.A. 5th, 1942) 131 F. (2d) 323; Earp v. Jones, (C.C.A. 10th, 1942) 131 F. (2d) 292; Schroder v. Commissioner, (C.C.A. 5th, 1943) 134 F. (2d) 346; Francis Doll, 2 T.C. 276 (1943), affirmed, (C.C.A. 8th, 1945) 149 F. (2d) 239; J. G. Fredeking, P-H (1943) MEMO. DEC. ¶43,464, 433 C.C.H. STANDARD FED. TAX SERV. ¶7754(M).

100 Schroder v. Commissioner, (C.C.A. 5th, 1943) 134 F. (2d) 346.

ment,[101] the wife has no voice in the conduct of the business,[102] and business is done in exactly the same way as it was prior to the partnership.[103] The wife receives her portion by virtue of the marital relationship, and not as a partner.[104]

When the motive for changes in the method of doing business is to avoid taxes, it is not too much to require that any changes be substantial.[105] But in these personal service family partnerships, whatever is earned is a result of the personal efforts of the taxpayer.[106] There can be no material changes in the way of doing business, so the partnership serves no business function.[107] When everything of value to the business is contributed by one individual, all of the profits are actually earned by that individual and are taxed to him.[108]

2. *What Constitutes "Service"*

If these partnerships are to be recognized at all, they should be recognized only if the challenged partner contributes services; for the profits are then the result of the joint efforts of the partners.[109] The question then arises, what are to be considered services?[110] If the

[101] Mead v. Commissioner, (C.C.A. 5th, 1942) 131 F. (2d) 323; Francis Doll, 2 T.C. 276 (1943), affirmed, (C.C.A. 8th, 1945) 149 F. (2d) 239; Frank J. Larkins, P-H (1945) MEMO. DEC. ¶45,029, 454 C.C.H. STANDARD FED. TAX SERV. ¶7258(M).

[102] Francis Doll, 2 T.C. 276 (1943), affirmed, (C.C.A. 8th, 1945) 149 F. (2d) 239; Schroder v. Commissioner, (C.C.A. 5th, 1943) 134 F. (2d) 346.

[103] Mead v. Commissioner, (C.C.A. 5th, 1942) 131 F. (2d) 323; Earp v. Jones, (C.C.A. 10th, 1942) 131 F. (2d) 292; Schroder v. Commissioner, (C.C.A. 5th, 1943) 134 F. (2d) 346; Waldburger v. Helvering, (C.C.A. 2d, 1942) 131 F. (2d) 598; Francis Doll, 2 T.C. 276 (1943), affirmed, (C.C.A. 8th, 1945) 149 F. (2d) 239; M. M. Argo, 3 T.C. 1120 (1944); J. G. Fredeking, P-H (1943) MEMO. DEC. ¶43,464, 433 C.C.H. STANDARD FED. TAX SERV. ¶7754(M); Frank J. Larkins, P-H (1945) MEMO. DEC. ¶45,029, 454 C.C.H. STANDARD FED. TAX SERV. ¶7258(M).

[104] Mead v. Commissioner, (C.C.A. 5th, 1942) 131 F. (2d) 323; A. Penziner v. United States, (D.C.Cal. 1944) 54 F. Supp. 842.

[105] Earp v. Jones, (C.C.A. 10th, 1942) 131 F. (2d) 292; Waldburger v. Helvering, (C.C.A. 2d, 1942) 131 F. (2d) 598.

[106] M. M. Argo, 3 T.C. 1120 (1944); G. Elliott Krusen, P-H (1944) MEMO. DEC. ¶44,287, 443 C.C.H. STANDARD FED. TAX SERV. ¶7714(M), affirmed, (C.C.A. 3d, 1945) 148 F. (2d) 210.

[107] Waldburger v. Helvering, (C.C.A. 2d, 1942) 131 F. (2d) 598; J. G. Fredeking, P-H (1943) MEMO. DEC. ¶43,464, 433 C.C.H. STANDARD FED. TAX SERV. ¶7754(M).

[108] Mead v. Commissioner, (C.C.A. 5th, 1942) 131 F. (2d) 323.

[109] Max German, 2 T.C. 474 (1943); Joseph A. Nash, P-H (1942) MEMO. DEC. ¶42,241, 423 C.C.H. STANDARD FED. TAX SERV. ¶7516-B.

[110] To whom are the services to be rendered? See M. W. Turner, Sr., P-H (1944) MEMO. DEC. ¶44,394, 443 C.C.H. STANDARD FED. TAX SERV. ¶7857(M),

services rendered are of the same kind or as essential to the business as those of the taxpayer, no real problem exists. But if the wife works in the office, doing a job which is worth $30.00 per week on the labor market, is she to be considered as having contributed services enough so that she may share equally the profits of a partnership which may earn twenty times that amount each week? This has been considered enough to support a family partnership in which services are the material income producing factor.[111] Services in an "advisory" capacity[112] or helping to design the firm's advertising[113] have also been considered enough, though the firm's income was not derived from the type of service rendered by the alleged partner.

a. *Validity of Partnership*

But the problem is seldom so simple as that presented in the purely personal service partnership. Often, both capital and services are material income producing factors. Are the partnerships then to be called valid because of the earnings which can be attributed to the invested capital; or are the arrangements to be held invalid because of the personal service elements?[114]

It has been stated that if most of the income of the partnership is due to personal services of the taxpayer, the family partnership will not be recognized; but that if most of the income is due to invested capital there can be a valid partnership.[115] When the alleged partner contributed no services, and the partnership is recognized because most of the income resulted from invested capital, this is recognizing a partial assignment of income. For to the extent that the earnings came from the personal services of the taxpayer, he is assigning his right to receive the income and being relieved of the attendant tax

where partnership held valid though services were rendered to an entirely different business enterprise than the one before the Court.

Cf. George A. Croft, P-H (1944) MEMO. DEC. ¶44,330, 443 C.C.H. STANDARD FED. TAX SERV. ¶7777(M).

[111] Felix Zukaitis, 3 T.C. 814 (1944); Clinton Davidson, 43 B.T.A. 576 (1941); Peter F. Loftus, P-H (1944) MEMO. DEC. ¶44,307, 443 C.C.H. STANDARD FED. TAX SERV. ¶7737(M).

[112] Peter F. Loftus, P-H (1944) MEMO. DEC. ¶44,307, 443 C.C.H. STANDARD FED. TAX SERV. ¶7737(M).

[113] E. R. Ledbetter, P-H (1942) MEMO. DEC. ¶42,039, 423 C.C.H. STANDARD FED. TAX SERV. ¶7401-G.

[114] Before a partnership can be held valid because capital is a material income producing factor, the court must assume that there can be a valid family partnership when the wife or children contribute no services and the only capital contributed was received as a gift from the taxpayer. This is discussed in the text, infra.

[115] M. M. Argo, 3 T.C. 1120 (1944). But six of the judges did not agree with the reasoning of the case, though concurring in result.

burden. Partial assignments of income through the medium of a partnership have thus been recognized,[116] while other partial assignments are held invalid under *Lucas v. Earl.*

b. *Incidence of the Tax*

But if a partnership was in fact formed, it should not be held invalid because a large part of its earnings resulted from the personal services of the taxpayer. For, to the extent that the earnings resulted from the invested capital of the challenged partner, the taxpayer is taxed on income he did not earn, receive or enjoy.

It seems that so long as a substantial part of the earnings are from capital, the partnership may be recognized.[117] The courts then tend to disregard the personal service aspects of the partnership and analyze it as if capital alone produced the earnings.[118] Other factors may then lead the court to hold that a valid partnership was not formed. If the business is conducted in the same way as before the partnership and the alleged partner has no control over the profits earned,[119] or if the arrangements have no real business function,[120] the partnership may not be recognized. If the partnership has a business function, it may be recognized for tax purposes, though the challenged partner is not active in the business.[121]

c. *Suggested Solution*

A practical solution to the problem would be to apportion the income of the partnership. The Tax Court could determine how much

[116] J. D. Johnston, Jr., 3 T.C. 799 (1944); Nathan, Grossman, Klein and Rosenberg, P-H (1943) MEMO. DEC. ¶43,232, 433 C.C.H. STANDARD FED. TAX SERV. ¶7392(M).

[117] J. D. Johnston, Jr., 3 T.C. 799 (1944). Cf. E. R. Ledbetter, P-H (1942) MEMO. DEC. ¶42,039, 423 C.C.H. STANDARD FED. TAX SERV. ¶7401-G; Peter F. Loftus, P-H (1944) MEMO. DEC. ¶44,307, 443 C.C.H. STANDARD FED. TAX SERV. ¶7737(M); Clinton Davidson, 43 B.T.A. 576 (1941). In each of these cases there was also a finding that services were rendered by the alleged partner.

[118] Montgomery v. Thomas, (C.C.A. 5th, 1944) 146 F. (2d) 76; R. C. Bennett, P-H (1941) MEMO. DEC. ¶41,408, 414 C.C.H. STANDARD FED. TAX SERV. ¶7656-C; Joe Lynch, P-H (1941) MEMO. DEC. ¶41,227, 414 C.C.H. STANDARD FED. TAX SERV. ¶7379-E.

[119] Charles F. Goodwin, P-H (1944) MEMO. DEC. ¶44,321, 443 C.C.H. STANDARD FED. TAX SERV. ¶7790(M); H. G. Whittenberg, Sr., P-H (1944) MEMO. DEC. ¶44,293, 443 C.C.H. STANDARD FED. TAX SERV. ¶7725(M).

[120] R. W. Camfield, P-H (1944) MEMO. DEC. ¶44,039, 443 C.C.H. STANDARD FED. TAX SERV. ¶7335(M).

[121] Nathan, Grossman, Klein and Rosenberg, P-H (1943) MEMO. DEC. ¶43,232, 433 C.C.H. STANDARD FED. TAX SERV. ¶7392(M).

of the firm's earnings were due to the invested capital and how much were due to the services of the taxpayer. This could be done by determining the amount of invested capital in the taxpayer's business; the balance of the earnings would be attributed to the services of the taxpayer. Then, to the extent that the wife invested capital in the firm, she could share in the earnings which resulted from capital in the same proportion as her investment bore to the total amount of capital employed. But she would not share in the earnings attributable to the services of her husband. If the wife contributed services, she could receive her just share of the earnings which those services produced.[122]

The Tax Court is well able to handle this method of computation. Mathematical exactness in determination is not necessary; a reasonable approximation is all that is required and that the Tax Court can make after hearing the evidence presented. It is no more difficult here than when the reasonable salary of a corporate officer is in issue.

In *Max German*[123] the Tax Court has already taken some steps in this direction. There the taxpayer and wife made a joint loan to go into business. Both worked in the business and built it up to a successful enterprise. Then the wife took a smaller part in its operation. The court held that since the wife was not active in the business now; though it had originally been a joint enterprise, the wife could share in the profits to the extent of only 25 per cent.

Of course the 25 per cent is just an approximation, but it is a reasonable one. It would not be just to tax all the profits to the husband because originally the wife was as responsible for the firm's growth and prosperity as the husband. To allow the wife to report one-half of the firm earnings would have given that family an unwarranted tax benefit. The solution adopted is fair to all parties; its use should be extended to cover the problem outlined above.

In *William J. Hirsch*[124] the government urged the Tax Court to adopt this view, contending that section 182 (c)[125] permitted such a result.

[122] When the Tax Court determined the amount of the partnership income which was due to the invested capital or to services, this would be a finding of fact. How much weight must an appellate court give to these findings of fact? Under the rule expounded in Dobson v. Commissioner, 320 U.S. 489, 64 S.Ct. 239 (1943), it would seem that the Tax Court's determination would be final and not subject to review.

[123] 2 T.C. 474 (1943). The decision is based on § 3797 (a) (2) of the Internal Revenue Code rather than on § 181.

[124] P-H (1945) MEMO. DEC. ¶45,002, 454 C.C.H. STANDARD FED. TAX SERV. ¶7209. Husband and wife each contributed capital and services.

[125] § 182: "In computing the net income of each partner, he shall include,

The Tax Court rejected the commissioner's argument, distinguishing the *German* case by stating that the commissioner had there denied the existence of a partnership and here conceded it. The Tax Court held that in the absence of agreement to the contrary, partnership profits are to be shared equally; there is a presumption that each partner devotes all his time to the business and the court will not attempt to evaluate the services of each partner.

Twenty-five years ago there was much to be said for the court's view. At present, the fact that parties say they have formed a partnership is not binding on the tax authorities; if the partnership is held valid, the decision of the parties as to respective shares of the profits need not be binding either.

The Tax Court is now determining the basis of corporate shares, reasonable compensation for corporate officers,[126] and what amount of a taxpayer's earnings is due to invested capital, so that the balance might be reported as community property.[127] To do the same in the case of a family partnership would not be setting a dangerous precedent.

C. *Analysis Where Capital Is Material Income Producing Factor*

Family partnerships, when capital is the material income producing factor, present to a court problems of analysis quite similar to those involved in personal service partnerships. In the latter situation the court must prevent an assignment of income from personal services; in the former the court must distinguish between an assignment of income from property and a transfer of the property itself with the rights to any earnings from that property. An assignment of income from property is ineffective to shift tax liability,[128] while a valid transfer of the property itself makes the transferee the new owner and taxable on the earnings.[129]

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 section 183 (b)."

[126] P-H (1945) MEMO. DEC. ¶¶45,003, 45,018, 45,049 and 45,084, 454 C.C.H. STANDARD FED. TAX SERV. ¶¶7210(M), 7229(M), 7273(M), 7339(M)—a few of the cases in the same volume following the Hirsch case in which reasonable compensation determined.

Cf. P-H (1945) MEMO. DEC. ¶45,011, 454 C.C.H. STANDARD FED. TAX SERV. ¶7224(M). The court undertook to allocate between business and private expense, the fees paid by a taxpayer to his lawyer.

[127] Lawrence Oliver, 4 T.C. 684 (1945).

[128] Helvering v. Horst, 311 U.S. 112, 61 S.Ct. 144 (1940).

[129] James O. Peterson, P-H (1943) MEMO. DEC. ¶43,491, 443 C.C.H. STAND-

To form a valid partnership there must be an agreement to form a partnership;[130] it must be presently effective, and not just purport to create a partnership in the future.[131] Then, if there is a contribution of services by the alleged partner, a partnership will probably be recognized.[132] In the absence of services by the alleged partner, a contribution of capital will be an acceptable substitute.[133] When the capital comes from the separate estate of the challenged partner, additional resources have been added to the enterprise and a real partnership is formed. But when the capital contribution comes from the taxpayer himself, either through a gift or a fictitious sale, it is difficult to see what the partner has contributed.[134]

This in itself is not reason enough to deny to the taxpayer the right to form a partnership with his family in this way.[135] For, if the taxpayer were conducting the same business through the medium of a corporation, he could give shares of stock to his wife or to his children. If the gift were unconditional, it would be effective to vest in the donee the right to receive any dividends on these shares; having received the dividends, the donee would be liable for the tax.[136]

Essentially, there is little difference between the two situations. A simple substitution of a partnership for a corporation should not lead to radically different tax burdens. In order to impose different

ARD FED. TAX SERV. ¶7134(M); Montgomery v. Thomas, (C.C.A. 5th, 1944) 146 F. (2d) 76.

Cf. Robert P. Scherer, 3 T.C. 776 (1944).

[130] Estate of Joe S. Ellis, P-H (1941) MEMO. DEC. ¶41,482, 413 C.C.H. STANDARD FED. TAX SERV. ¶7748-D.

Cf. George A. Croft, P-H (1944) MEMO. DEC. ¶44,330, 443 C.C.H. STANDARD FED. TAX SERV. ¶7777(M), as to how little evidence is needed to find the necessary intent.

[131] Joseph Supornick, P-H (1943) MEMO. DEC. ¶43,481, 433 C.C.H. STANDARD FED. TAX SERV. ¶7787(M).

[132] Benjamin Shander, P-H (1943) MEMO. DEC. ¶43,123, 443 C.C.H. STANDARD FED. TAX SERV. ¶7266(M); Sidney M. Harvey, P-H (1942) MEMO. DEC. ¶42,554, 423 C.C.H. ¶7863-A; George A. Croft, P-H (1944) MEMO. DEC. ¶44,330, 443 C.C.H. STANDARD FED. TAX SERV. ¶7777(M); M. W. Turner, Sr., P-H (1944) MEMO. DEC. ¶44,394, 443 C.C.H. STANDARD FED. TAX SERV. ¶7857(M) (contribution of services by the daughter-in-law).

[133] Montgomery v. Thomas, (C.C.A. 5th, 1944) 146 F. (2d) 76.

[134] Blalock v. Allen, (D.C. Ga. 1944) 56 F. Supp. 266; R. W. Camfield, P-H (1944) MEMO. DEC. ¶44,039, 443 C.C.H. STANDARD FED. TAX SERV. ¶7335(M).

See J. D. Johnston, 3 T.C. 799 (1944), dissenting opinion.

[135] Hardymon v. Glenn, (D.C. Ky. 1944) 56 F. Supp. 269; M.W. Smith, Jr., 3 T.C. 894 (1944); R. C. Bennett, P-H (1941) MEMO. DEC. ¶41,408, 413 C.C.H. STANDARD FED. TAX SERV. ¶7656-C; Joe Lynch, P-H (1941) MEMO. DEC. ¶41,227, 413 C.C.H. STANDARD FED. TAX SERV. ¶7379-E; Irene McCullough, P-H (1944) MEMO. DEC. ¶44,236, 443 C.C.H. STANDARD FED. TAX SERV. ¶7648(M).

[136] Bardach v. Commissioner, (C.C.A. 6th, 1937) 90 F. (2d) 323.

tax burdens, there should be substantial differences in methods of doing business. The interposition of a corporate entity does not seem to be so substantial a difference as to require a different result. This is especially true today; courts have disregarded the corporate entity when they thought it necessary to do so to reach a desirable result.[137] The tax statute itself, in imposing the tax, disregards the partnership entity,[138] while the partnership entity is recognized when the partnership makes a sale of property contributed by a partner.[139] The policy of the tax statute, rather than strict adherence to legal theory seems to be determinative.[140] It is submitted that the statute does not require, nor does logic compel, a difference in tax burdens in two situations outlined above. If a man may make a valid gift of shares of a corporation to his wife or children, he ought to be allowed to make a gift of the assets of a partnership.[141]

1. *The Split in the Tax Court*

The question whether a taxpayer ought to be allowed to make a gift to members of his immediate family of the financial assets of his business and form a partnership with them has caused wide differences of opinion among the members of the Tax Court. Some of the judges feel that since the present statute does not forbid family partnerships of this sort, if the formal requirements of a partnership have been met, the partnership ought to be allowed.[142] They realize that to recognize family partnerships is to allow a large measure of tax avoidance, but do not feel that the doctrine of the *Clifford* case ought to be extended so far as to condemn this situation.[143]

[137] Griffiths v. Commissioner, 308 U.S. 355, 60 S.Ct. 277 (1939); Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266 (1935).

[138] Internal Revenue Code, § 181.

[139] Helvering v. Walbridge, (C.C.A. 2d, 1934) 70 F. (2d) 683.

[140] Higgins v. Smith, 308 U.S. 473 at 477, 60 S.Ct. 355 (1940). "The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the statute."

[141] Montgomery v. Thomas, (C.C.A. 5th, 1944) 146 F. (2d) 76, and Robert P. Scherer, 3 T.C. 776 (1944), are authorities holding that if a valid gift of property was made, the partnership will be recognized for tax purposes.

[142] Robert P. Scherer, 3 T.C. 776 (1944); M.W. Smith, Jr., 3 T.C. 894 (1944); J. D. Johnston, Jr., 3 T.C. 799 (1944).

Cf. Justin Potter, 47 B.T.A. 607 (1942); R. C. Bennett, P-H (1941) MEMO. DEC. ¶41,408, 413 C.C.H. STANDARD FED. TAX SERV. ¶7656-C; Irene McCullough, P-H (1944) MEMO. DEC. ¶44,236, 443 C.C.H. STANDARD FED. TAX SERV. ¶7648 (M).

[143] Robert P. Scherer, 3 T.C. 776 (1944).

Another and more radical group within the Tax Court think that the *Clifford* doctrine can be extended to cover these facts without doing violence to the views of the Supreme Court.[144] They do not deny that if the taxpayer makes a valid gift, he can form a partnership with members of his family. But they do make it so difficult to prove relinquishment of all control over the intended gift that unless other factors having independent probative effect are also present, the gift will be held invalid.[145] In *O. William Lowry*[146] the taxpayers had been conducting, through the medium of a corporation, a furniture manufacturing business. One and one-half years before the dissolution of the corporation and the formation of the challenged partnership, one of the taxpayers made a gift of shares to his wife. This was held to be in anticipation of the creation of the partnership and not a valid gift.

The views of the conservative wing of the Tax Court can be seen in *J. D. Johnston, Jr.*[147] There the taxpayer had been in partnership with his father, manufacturing peanut butter. In contemplation of a new partnership, he sold half his interest to his wife. The wife gave an unsecured note to pay for her interest. This note was to be paid out of the future earnings of the business. It does not appear that the wife had substantial separate property so that the note would have any real value. A valid partnership was found on these facts; the court held that the wife contributed capital.[148]

In *M. W. Smith, Jr.*[149] the taxpayer made a gift of a one-half interest in his lumber company to his wife. A valid partnership was found, although the wife contributed no services and the business was conducted in the name of the husband. The court distinguished the

[144] Francis E. Tower, 3 T.C. 396 (1944), reversed, (C.C.A. 6th, 1945) 148 F. (2d) 388; O. William Lowry, 3 T.C. 730 (1944); Frank J. Lorenz, 3 T.C. 746 (1944), affirmed, (C.C.A. 6th, 1945) 148 F. (2d) 527.

Cf. A. L. Lusthaus, 3 T.C. 540 (1944), affirmed, (C.C.A. 3d, 1945)—F. (2d)—.

[145] O. William Lowry, 3 T.C. 730 (1944).

[146] 3 T.C. 730 (1944).

Cf. Francis E. Tower, 3 T.C. 396 (1944), reversed, (C.C.A. 6th, 1945) 148 F. (2d) 388; Frank J. Lorenz, 3 T.C. 746 (1944), affirmed, (C.C.A. 6th, 1945) 148 F. (2d) 527.

[147] 3 T.C. 799 (1944).

[148] A fictitious sale is no different from a gift. In neither case is capital added to the firm: the firm does not have greater credit than it had previously, the credit of the firm is still based on the credit rating of the taxpayer.

Cf. Blalock v. Allen, (D.C. Ga. 1944) 56 F. Supp. 266.

[149] 3 T.C. 894 (1944).

Lowry decision by saying that, there, no valid gift was made. This is obviously the weakest kind of reasoning. The question whether a valid gift was made is a mixed question of law and fact. The fact is the attempted transfer of rights in property; whether the transfer will be raised to the status of a gift depends on the applicable law. To distinguish the facts of one case from those of another by a conclusion of law is not in any way explaining the differences, if any, involved.[150]

2. *The Scherer Decision*

The more radical wing of the Tax Court which has sought to extend the doctrine of *Helvering v. Clifford* has met with an important setback in the *Robert P. Scherer* case.[151] The taxpayer there set

[150] There is no logical reason for considering a finding that a valid gift was made as purely a finding of fact. If the Tax Court determines that shares of a closely held corporation are worth *X* dollars per share, that type of finding ought not to be disturbed. The appellate court may feel that the result is not exactly right, but efficient administration of the revenue laws can not be achieved if this were to be redetermined in each reviewing court; there is no "right answer" and a reasonable approximation is all that is necessary.

In the family partnership situation, a question of policy is involved; are we going to permit a tax avoidance scheme to succeed? The appellate courts must be permitted to guide policy; the result ought not to be determined by the fortuitous assignment of a sympathetic judge to try the case.

The present policy of the Supreme Court is to give weight to findings of fact made by an administrative board. Gray v. Powell, 314 U.S. 402, 62 S.Ct. 326 (1941); Dobson v. Commission, 320 U.S. 489, 64 S.Ct. 239 (1943). If the findings are reasonably rooted in the evidence, the Court feels that appellate review of the facts found is not desirable.

However well this system may work in other administrative situations, even where the Tax Court itself is involved, such a rule, if the finding of a valid gift is to be called a finding of fact, does not seem desirable here. There are fourteen judges on the Tax Court; they do not agree on what facts are necessary to constitute a valid partnership. See text, supra. The decision in the case may depend on which of the fourteen tries the case. If a finding that no valid gift was made is to be considered a finding of fact and not subject to review, there can be no guides to developing a uniform technique for dealing with these cases. This is especially true in a family partnership situation since the taxpayer usually takes great pains to see that the formal requirements of a partnership have been met and it is therefore nearly impossible to say that there is no substantial evidence to support the decision.

The weaknesses of the view expounded in the Dobson case, supra, are further emphasized by the fact that the taxpayer retains the option of taking his case before the Tax Court, or (after paying the assessed deficiency) suing for a refund in the Federal District Court. Cases are subject to review of facts found. This could easily result in having two constrasting methods of handling a family partnership in vogue in the Tax Court, and other techniques in use in each of the ten circuits and the District of Columbia.

[151] 3 T.C. 776 (1944), acquiescence, T.C. 109825, INT. REV. BUL. 1944-17-11837.

up four trusts for each of his minor children with his wife as trustee. To each trust he gave a share of the assets of his business, and then entered into a partnership with the trusts and his wife. The taxpayer retained exclusive power to determine what amount of the firm profits would be distributed. He could force a dissolution of the partnership, and upon dissolution would get a larger share of the firm assets than he had received of the firm profits. The gifts were held valid and the partnership recognized; the commissioner acquiesced in the decision.

The acquiescence may be based on the fact that the Commissioner of Internal Revenue had assessed a gift tax, thus to some extent conceding the validity of the gift.[152] Opper, Judge of the Tax Court, did not think that this assessment was binding on the commissioner, for the taxpayer did not force him to elect which of the two inconsistent positions he would maintain.[153] Unwilling to impose different tax burdens in similar cases, Opper has reluctantly followed the *Scherer* case.[154]

3. *Trusts as Partners*

If the partnership which is being challenged involves a trust, what rules are to be followed in determining whether such a partnership is to be recognized? There have been a great many decisions determining the status of trusts under sections 166 and 167 of the Internal Revenue Code. If the trust income is not taxable to the settlor under these sections, will the addition of the family partnership factor result in taxing trust income to the settlor?[155] The fact that the partner is a trust instead of an individual should not in itself make the trust's distributive share of the income taxable to the settlor. But under the *Clifford* case, retention of control over the trust corpus will make the income taxable to the settlor under section 22 (a) of the Internal Revenue Code. The partnership then becomes important in determining whether the settlor has retained such control.

In the *Scherer* case, trusts for minor children were recognized as members of the partnership. The trustee, wife of the settlor, had no

[152] Cf. Estate of Fred E. Barringer, P-H (1942) MEMO. DEC. ¶42,504, 423 C.C.H. STANDARD FED. TAX SERV. ¶7830-C.

[153] Philip M. McKenna, P-H (1944) MEMO. DEC. ¶44,312, 443 C.C.H. STANDARD FED. TAX SERV. ¶7758(M).

[154] Ibid.

[155] In most of these cases the taxpayer is the settlor of the trust as well as the manager of the partnership business. Losh v. Commissioner, 1 T.C. 1019 (1943), affirmed, (C.C.A. 10th, 1944) 145 F. (2d) 456; Armstrong v. Commissioner, (C.C.A. 10th, 1944) 143 F. (2d) 700; Robert P. Scherer, 3 T.C. 776 (1944); Rose Mary Hash, 4 T.C. 878 (1945).

business experience, and the taxpayer managed the trust estates as well as the partnership business.[156] The Tax Court found that control over the trust property was exercised by the taxpayer as manager of the partnership not as settlor or trustee, and that the *Clifford* rationale did not, therefore, apply.[157]

When the settlor was trustee as well as manager of the business, retaining unlimited discretion as to investments, and the corpus would revert to the settlor if the beneficiaries died before the termination of the trust, the income was taxed to the settlors.[158] The retention of the right to extend the duration of the trust,[159] restraints on alienation after termination of the trust,[160] or the reservation of the right to remove any beneficiary[161] were additional factors resulting in the application of the *Clifford* doctrine.

Without considering the *Clifford* doctrine, the trust may not be recognized as a partner. For when no profits were in fact paid to the trust,[162] or if the amount of the trust's capital interest in the partnership had not been fixed or paid,[163] it is difficult to hold that the trust is a valid member of the partnership.

D. *Some General Observations*

When hearing family partnership cases, courts appear to have difficulty in formulating legal standards. Each case seems to stand on its own particular facts.[164] It is often difficult to determine what is the exact issue before the court. Sometimes it is a question as to whether a valid gift was made with the donee getting dominion and control;[165]

[156] A large part of the firm profits was due to the personal services of the taxpayer. The trustee had discretionary powers regarding distribution of trust income to the beneficiaries. These powers were exercised by the taxpayer.

[157] Accord, Armstrong v. Commissioner, (C.C.A. 10th, 1944) 143 F. (2d) 700. Cf. Justin Potter, 47 B.T.A. 607 (1942), acquiescence, T.C. 97018 (1943) INT. REV. BUL. 18, where the powers exercised were held by operation of law.

[158] Rose Mary Hash, 4 T.C. 878 (1945); Losh v. Commissioner, 1 T.C. 1019 (1943), affirmed, (C.C.A. 10th, 1944) 145 F. (2d) 456.

[159] Losh v. Commissioner, 1 T.C. 1019 (1943), affirmed, (C.C.A. 10th, 1944) 145 F. (2d) 456.

[160] Ibid.

[161] Rose Mary Hash, 4 T.C. 878 (1945).

[162] Ibid.; Tyson v. Commissioner, (C.C.A. 8th, 1944) 146 F. (2d) 50.

[163] Tyson v. Commissioner, (C.C.A. 8th, 1944) 146 F. (2d) 50.

[164] E. R. Ledbetter, P-H (1942) MEMO. DEC. ¶42,039, 423 C.C.H. STANDARD FED. TAX SERV. ¶7401-G. See J. D. Johnston, 3 T.C. 799 (1944), dissent.

[165] O. William Lowry, 3 T.C. 730 (1944). Cf. M. W. Smith, Jr., 3 T.C. 894 (1944), where the issue seemed to be whether a completed gift was made.

or, the issue may be the good faith of the gift,[166] or even whether there was a "bona fide intent to create and maintain a partnership."[167]

Different judges will draw widely contradictory inferences from the same or similar facts.[168] The purpose in forming the partnership may have been to avoid taxes. That in itself is not generally considered enough of a reason for invalidating a partnership,[169] and they have been recognized despite that motive. However, the Tax Court, on substantially similar facts, has held a partnership invalid.[170] On other facts, a legitimate business purpose may outweigh the tax avoidance motive.[171] The business of the taxpayer may have been conducted in the same manner after the partnership was formed as it had been previously. In cases in which the trial judge considered that a factor in his decision, contradictory results were reached.[172]

If the people doing business with the partnership do not know that it is a partnership, that is generally evidence that no partnership was formed;[173] but it has not prevented family partnerships from being recognized.[174] Nor did conducting the business in the name of the husband defeat the partnership.[175] Even the fact that no present interest in the firm assets was given to the alleged partner has not in all cases made the partnership invalid for tax purposes.[176] When the

[166] Sidney M. Harvey, P-H (1944) MEMO. DEC. ¶44,309, 443 C.C.H. STANDARD FED. TAX SERV. ¶7754(M).

[167] Hardymon v. Glenn, (D.C. Ky. 1944) 56 F. Supp. 269.

[168] Compare M. W. Smith, Jr., 3 T.C. 894 (1944), and J. D. Johnston, Jr., 3 T.C. 799 (1944), with O. William Lowry, 3 T.C. 730 (1944), and Francis E. Tower, 3 T.C. 396 (1944), reversed, (C.C.A. 6th, 1945) 148 F. (2d) 388.

[169] Hardymon v. Glenn, (D.C. Ky. 1944) 56 F. Supp. 269; M. W. Turner, Sr., P-H (1944) MEMO. DEC. ¶44,394, 443 C.C.H. STANDARD FED. TAX SERV. ¶7857(M).

[170] Francis E. Tower, 3 T.C. 396 (1944), O. William Lowry, 3 T.C. 730 (1944).

[171] Benjamin Shandler, P-H (1943) MEMO. DEC. ¶43,123, 433 C.C.H. STANDARD FED. TAX SERV. ¶7266(M); M. W. Turner, Sr., P-H (1944) MEMO. DEC. ¶44,394, 443 C.C.H. STANDARD FED. TAX SERV. ¶7857(M).

[172] A. L. Lusthaus, 3 T.C. 540 (1944), affirmed, (C.C.A. 3d, 1945)—F. (2d)—; Joseph W. Grant, P-H (1944) MEMO. DEC. ¶44,254, 443 C.C.H. STANDARD FED. TAX SERV. ¶7674(M) (both held not valid); J. D. Johnston, Jr., 3 T.C. 799 (1944) (valid).

[173] Joseph W. Grant, P-H (1944) MEMO. DEC. ¶44,254, 443 C.C.H. STANDARD FED. TAX SERV. ¶7674(M). Stanley Bradshaw, P-H (1944) MEMO. DEC. ¶44,249, 443 C.C.H. STANDARD FED. TAX SERV. ¶7673(M).

[174] M. W. Smith, Jr., 3 T.C. 894 (1944); Sidney M. Harvey, P-H (1942) MEMO. DEC. ¶42,554, 423 C.C.H. STANDARD FED. TAX SERV. ¶7863-A.

[175] M. W. Smith, Jr., 3 T.C. 894 (1944).

[176] Benjamin Shander, P-H (1943) MEMO. DEC. ¶43,123, 433 C.C.H. STANDARD FED. TAX SERV. ¶7266(M).

But see Joseph Supornick, P-H (1943) MEMO. DEC. ¶43,481, 433 C.C.H.

taxpayer retains control of the operation and management of the business, some judges have considered that strong evidence that no real partnership was forced;[177] others have felt that such retention of control was not at all unusual and did not invalidate the partnership.[178]

Perhaps the decision, when all the formal requirements of a valid partnership have been fulfilled, will be determined by the attitude of the taxpayer toward the partnership.[179] Did he treat it as a partnership, or did all his actions deny its existence? [180] If the profits were not distributed in proportion to the record ownership; [181] if the wife's share was used to pay the husband's obligations,[182] or returned to the business; [183] if the taxpayer withdrew all the profits himself,[184] or if the taxpayer signed business contracts as the sole proprietor; [185] it is difficult to hold that a real partnership was formed. But if the taxpayer

STANDARD FED. TAX SERV. ¶7787(M); Robert Walker Tyson, P-H (1944) MEMO. DEC. ¶44,060, 443 C.C.H. STANDARD FED. TAX SERV. ¶7384(M), which held family partnerships invalid on these grounds.

[177] O. Wm. Lowry, 3 T.C. 730 (1944); Frank J. Lorenz, 3 T.C. 746 (1944), affirmed, (C.C.A. 6th, 1945) 148 F. (2d) 527; Joseph W. Grant, P-H (1944) MEMO. DEC. ¶44,254, 443 C.C.H. STANDARD FED. TAX SERV. ¶7674(M); Stanley Bradshaw, P-H (1944) MEMO. DEC. ¶44,249, 443 C.C.H. STANDARD FED. TAX SERV. ¶7673(M). Cf. Robert Walker Tyson, P-H (1944) MEMO. DEC. ¶44,060, 443 C.C.H. STANDARD FED. TAX SERV. ¶7384(M).

[178] Hardymon v. Glenn, (D.C. Ky. 1944) 56 F. Supp. 269; Francis E. Tower, (C.C.A. 6th, 1945) 148 F. (2d) 388.

Cf. Robert P. Scherer, 3 T.C. 776 (1944); Joe Lynch, P-H (1941) MEMO. DEC. ¶41,227, 413 C.C.H. STANDARD FED. TAX SERV. ¶7379-E; Benjamin Shander, P-H (1943) MEMO. DEC. ¶43,122, 433 C.C.H. STANDARD FED. TAX SERV. ¶7266(M).

[179] Compare Earp v. Jones, (C.C.A. 10th, 1942) 131 F. (2d) 292, certiorari denied, 318 U.S. 764, 63 S.Ct. 665 (1943); and Mead v. Commissioner, (C.C.A. 5th, 1942) 131 F. (2d) 323, where the partnerships were not recognized, with E. R. Ledbetter, P-H (1942) MEMO. DEC. ¶42,039, 423 C.C.H. STANDARD FED. TAX SERV. ¶7401-G; and Peter F. Loftus, P-H (1944) MEMO. DEC. ¶44,307, 443 C.C.H. STANDARD FED. TAX SERV. ¶7737(M), which recognized the partnership.

[180] Benjamin Shander, P-H (1943) MEMO. DEC. ¶43,123, 433 C.C.H. STANDARD FED. TAX SERV. ¶7266(M).

[181] W. P. Sewell, P-H (1944) MEMO. DEC. ¶44,040, 443 C.C.H. STANDARD FED. TAX SERV. ¶7332(M).

[182] Robert Walker Tyson, P-H (1944) MEMO. DEC. ¶44,060, 443 C.C.H. STANDARD FED. TAX SERV. ¶7384(M). But see Francis E. Tower, 3 T.C. 396 (1944), reversed, (C.C.A. 6th, 1945) 148 F. (2d) 388.

[183] Joseph W. Grant, P-H (1944) MEMO. DEC. ¶44,254, 443 C.C.H. STANDARD FED. TAX SERV. ¶7674(M).

[184] Frank J. Lorenz, 3 T.C. 746 (1944), affirmed, (C.C.A. 6th, 1945) 148 F. (2d) 527.

Cf. Blalock v. Allen, (D.C. Ga. 1944) 56 F. Supp. 266.

[185] Stanley Bradshaw, P-H (1944) MEMO. DEC. ¶44,249, 443 C.C.H. STANDARD FED. TAX SERV. ¶7673(M).

obtained additional credit for the partnership because of the wife's participation,[186] or if the profits were used by the wife to pay for her separate property,[187] a partnership may be found on otherwise similar facts.

On the present state of the authorities, there appear to be few principles which will be generally applicable in the decision of family partnership cases. It does seem, at least in partnerships in which capital is a material income producing factor, that if a valid gift was made, the partnership will be recognized.[188]

State law is no longer important in the decision of family partnership cases,[189] and a state adjudication is not binding on the commissioner. When a state adjudication is held to be material, it is because the Revenue Acts have left the determination of status to the local law.[190]

VI

CONCLUSION

Congress can solve many of the difficulties which the courts have encountered in dealing with family partnerships. It could provide for returns which taxed income to the family unit, and not to the individual earner of income. This solution would be comparable to cutting the Gordian knot; it is a solution of doubtful wisdom. Many more women are now gainfully employed than ever before, and many women will go into business with their husbands after the war. They will be business women, and take an active part in the business. To forbid family partnerships will discriminate against the genuine family business arrangements.

An alternative solution would be to permit family partnerships

[186] James O. Peterson, P-H (1943) MEMO. DEC. ¶43,491, 443 C.C.H. STANDARD FED. TAX SERV. ¶7134(M).

[187] R. C. Bennett, P-H (1941) MEMO. DEC. ¶41,408, 413 C.C.H. STANDARD FED. TAX SERV. ¶7656-C.

[188] Hardymon v. Glenn, (D.C. Ky. 1944) 56 F. Supp. 269; Montgomery v. Thomas, (C.C.A. 5th, 1944) 146 F. (2d) 76; Tower v. Commissioner, (C.C.A. 6th, 1945) 148 F. (2d) 388.

Cf. Robert P. Scherer, 3 T.C. 776 (1944); Whayne v. Glenn, (D.C. Ky. 1945) 59 F. Supp. 517.

[189] Stanley Bradshaw, P-H (1944) MEMO. DEC. ¶44,249, 443 C.C.H. STANDARD FED. TAX SERV. ¶7673(M); Frank J. Lorenz, 3 T.C. 746 (1944), affirmed, (C.C.A. 6th, 1945) 148 F. (2d) 527; A. L. Lusthaus, 3 T.C. 540 (1944), affirmed, (C.C.A. 6th, 1945)—F. (2d)—; M. M. Argo, 3 T.C. 1120 (1944).

Cf. E. C. Ellery, 4 T.C. 407 (1944).

[190] Doll v. Commissioner, 2 T.C. 276 (1943), affirmed, (C.C.A. 8th, 1945) 149 F. (2d) 239.

only when the alleged partner takes an active part in the business. If the wife is active in the business and a real partner, the family partnership should be recognized. This would eliminate all the phony family arrangements which are giving the courts so much trouble.

When Congress, in 1937, was seeking to block up the loopholes in the tax laws and prevent tax avoidance, the family partnership was considered an unimportant avoidance device and Congress neglected to take action on the problem.[191] Since that time it has had greater popularity. It is time for Congress to reconsider the problem and take steps to combat its spread.

Under the present taxing statute, personal service partnerships are not recognized and should not be recognized unless the alleged partner contributes services. If the partnership derives income from capital and personal services, the partnership should be recognized only to the extent of the contribution by the alleged partner; if the partner contributes capital, he should be permitted to share in the income produced by capital. He ought to receive only such portion of that income as his contribution bore to the total amount of capital invested. The same method of computation should be used if the partner contributed services.

If capital is the material income producing factor, and the alleged partner participates in the conduct of the business, the partnership should be recognized. If the only participation is a contribution of capital, the partnership should be recognized if the capital came from the partner's separate property and added to the funds available to conduct the business. If the only contribution to the firm had previously been received as a gift from the taxpayer, the partnership should be recognized if taxpayer has parted with all control over that property and the parties otherwise conduct themselves as if a valid partnership had been created. The decision in *Helvering v. Clifford* should not be extended to cover this situation. It is the job of Congress, not of the courts, to plug the loopholes in the Internal Revenue Code.

[191] H. Doc. 337, 75th Cong., 1st sess. (1937) 7.