TAXATION: A TRUST AS A FAMILY PARTNER

Despite the income-splitting provisions of the Revenue Act of 1948,[1] the problem of family partnerships still exists. As a result of the 1948 Act, partnerships between husband and wife became of little consequence as a method of avoiding high brackets. However, that objective has not disappeared with respect to partnerships between members of a family other than spouses.

In the Revenue Act of 1913, as in all subsequent acts, Congress provided that persons carrying on business in "partnership" were to be liable to taxation only on their distributive shares of the profits of the business. Congress did not, however, define the word "partnership." Was it intended that the question as to the existence of a tax partnership was to be determined by local law?

With respect to the Revenue Acts prior to 1932, it was settled by the Supreme Court that local law was not controlling.[2] The controlling law was that which would give a uniform interpretation of the tax statutes throughout the states.[3] The Revenue Act of 1932, however, contained a definition of "partnership" and "partner." Since that Act, the Regulations have included a statement to the effect that local law is not controlling in determining what is a partnership; and a statement that the term "partnership" as used in the statute is "broader in its scope" than the common law meaning of the term. While the former statement repeats what was already the law, the latter changes that law[4] by extending the scope of the word and adding that it "includes groups not commonly called partnerships." Thus, the statute itself is the measure to be used in determining what is a partnership.[5]

It is apparent from the statute that a "partnership" exists where: (1) a business, financial operation, or venture; (2)

[1] *Int. Rev. Code* § 12(d).

[2] Burk-Waggoner Oil Ass'n v. Hopkins, 269 U. S. 110 (1925).

[3] Burnet v. Harmel, 287 U. S. 102, 110 (1932).

[4] Wild v. Comm'r, 62 F.2d 777, 780 (2d Cir. 1933); *cf.* Comm'r v. N. B. Whitcomb, 95 F. 2d 596 (5th Cir. 1938).

[5] Paul, *Partnerships in Tax Avoidance*, 13 *Geo. Wash. L. Rev.* 121 (1945).

is carried on; (3) by a syndicate, group, pool, joint venture, or other unincorporated organization, which is not a trust, estate or corporation within the meaning of the Internal Revenue Code. The statute, after defining the word partnership provides "and the term 'partner' includes a member in such a syndicate, group, pool, joint venture, or organization." Based on the meaning of the latter words it would seem that a "member" would be a person who has become "associated" by agreeing with others to operate the activity.

The statute makes no express distinction between competent and incompetent members. As stated above, since the Revenue Act of 1948, the question of a wife's capacity to be a partner is no longer significant. And with respect to persons *non compos mentis* the question is of minor importance.[6] However, the question becomes pertinent in the discussion of family partnerships because in many of them one or more of the associates is a minor.

Since the partners are "associated" by "agreements," it is a reasonable assumption that the statute includes all persons capable, under the general law, of entering into agreements. In view of the general rule that a minor's contracts are valid until disaffirmed, it would seem that uniformity would best be obtained by adoption of the rule that minors are competent to become partners. No case has refused to recognize minors as partners, solely because of their age.[7]

Assuming that a minor may be a partner, what requirements must be fulfilled before the minor acquires the status of a *bona fide* partner? It had been indicated under the Revenue Acts prior to the Revenue Act of 1932[8] and was announced thereafter,[9] that a person could not be a partner unless he contributed either capital or services to the partnership. But the last word on family partnerships was spoken, as to a father and son partnership, in the *Culbertson* case.[10]

In the *Culbertson* case, the question was whether income from a cattle business should be taxed to a father and sons

[6] See Julius Goldenberg, 5 B.T.A. 213 (1926).
[7] *Cf.* S. J. Lidov, 16 B.T.A. 1421 (1929).
[8] B. M. Phelps, 13 B.T.A. 1248 (1928).
[9] Clarence L. Fox, 5 T.C. 242 (1945); C. Thorrez, 5 T.C. 60 (1945).
[10] Commissioner v. Culbertson, 337 U. S. 733 (1949).

as partners or to the father alone. The Supreme Court held that neither the Tax Court nor the Court of Appeals had used proper methods in deciding that issue. It explained how the tests set out in the *Tower* case[11] should be applied and remanded the case to the Tax Court to find the true intent of the parties.

The significance of the *Culbertson* decision lies in the de-emphasis of the tests of "original" capital and "vital" services in deciding the tax consequences of a family partnership. Chief Justice Vinson, speaking for the Court, asserted that the true test of a valid partnership for tax purposes is intent—whether the "parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[12]

Parent-child partnerships often raise a two-sided question with tax and other overtones. On the one hand, if the children are minors, how may their interests be properly protected and, on the other hand, how may they assume the role of real partners that will secure the tax division sought? One possible answer would appear to be to set up a trust for the children and make the trust a partner in the parent's business.

Whether a trust may be a partner for purposes of the Federal Income Tax would seem to depend upon a number of factors.

First, is the existence of a valid partnership to be determined by State law or Federal law? The courts have held that State law will be applied in determining rights or interests but Federal law controls the manner in which these rights or interests are to be taxed. In some cases, however, even though rights or interests have become fixed under State law, the Federal statute may be applied so as to override the effect of the State law, insofar

[11] Commissioner v. Tower, 327 U. S. 280 (1946). In *Tower* and *Lusthaus* (327 U. S. 293 (1946), it was stated that whether or not a valid partnership for tax purposes was formed depended on the intent of the parties, and that where the wife's capital came from a gift from her husband, and she did not perform vital services, nor participate in management, there was sufficient evidence to uphold the Tax Court's finding that no partnership was intended.

[12] 337 U.S. at 742.

as taxation is concerned.[13] Thus, if under the State law a valid partnership is found, it may be disregarded for Federal tax purposes unless there is clearly intended to be a *bona fide* business partnership.[14] So it may be pertinent to inquire whether there can be a *bona fide* business partnership when a trust is involved.

Generally, if a husband makes a gift of an interest in his business to his wife or child through the medium of a trust, no original capital is considered to have been invested by these donees.[15] Also the trust's share of the income may be taxable to the grantor under the rule of *Helvering v. Clifford*[16] because of retention by the grantor of dominion and control of the trust corpus or income.[17] Then, contributions by the trusts to the partnership are considered contributions by the trusts' grantors.[18] In some cases, however, the courts have refused to apply the *Clifford rule*.[19] Also, trusts have been recognized on the basis of separate capital contributed by beneficiaries;[20] and juries have recognized children's trusts as valid partners even though the capital they contributed came to them as gifts from the father.[21]

If under the applicable State law, no valid partnership can be found it would seem that the entity would not be treated as a partnership for tax purposes unless the ar-

[13] See Lyeth v. Hoey, 305 U. S. 188 (1938).

[14] Commissioner v. Culbertson, *supra* note 10.

[15] Zander v. Comm'r, 173 F.2d 624 (5th Cir. 1949); Jerry Maiatico, 12 T.C. 146 (1949); Kohl v. Comm'r, 170 F.2d 531 (8th Cir. 1948).

[16] 309 U. S. 331 (1940).

[17] Stanback v. Robertson, 183 F.2d 889 (4th Cir. 1950); Eisenberg v. Comm'r, 161 F.2d 506 (3rd Cir. 1947); S. K. Alexander, 6 T.C. 804 (1946); Hash v. Comm'r, 152 F.2d 722 (4th Cir. 1945).

[18] Comm'r v. Culbertson, supra note 10; Herman Schaeffer v. Comm'r, 174 F.2d 827 (3d Cir. 1949); Armstrong v. Comm'r, 143 F.2d 700 (10th Cir. 1944).

[19] Thomas v. Feldman, 158 F.2d 488 (5th Cir. 1946); Goerlich, P-H 1947 TC *Mem. Dec.* § 47,012. In the *Culbertson* case, the Supreme Court said: "If the donee of property who then invests it in the family partnership exercises dominion and control over that property—and through that control influences the conduct of the partnership and the disposition of its income—he may very well be a true partner."

[20] Florence R. Miller, P-H 1949 TC *Mem. Dec.* § 49,001; Goerlich, P-H 1947 TC *Mem. Dec.* § 47,012.

[21] Thompson v. Riggs, 175 F.2d 81 (8th Cir. 1949); Gorrard v. Campbell, 81 F. Supp. 752 (N. D. Ill. 1949).

rangement amounts to a joint enterprise or some sort of organization which is taxed as a partnership.[22] If under State law the trust has no legal right to withdraw partnership income, then all income would be taxed to the person legally entitled to it and the income paid to the trust would be treated as a gift.

Since the status of the partnership with a trust will be extremely doubtful for tax purposes unless such a partnership is clearly valid under State law, the rules of partnership law that will probably be applied in the State courts must be considered. For one thing, no partnership would seem to exist unless a clear authorization therefor is contained in the trust instrument. Otherwise the intent of the settlor would seem to be contravened, for he apparently meant for the trustee to own and manage the property, not for it to be held in co-ownership and to be subject to the liabilities incurred for the partnership by the other partners.

If there is an explicit authorization to enter the partnership, the grantor's assumed intent will be superseded by his express intent; but another provision of the trust would probably still have to be consulted in order to determine the partnership's validity. If there is an immunities provision in the trust, shielding beneficiaries and trustees alike from all personal liability—and such provisions are the rule rather than the exception—the partnership with the trust becomes a "partnership" with an aggregate of capital rather than with a person. This is not a limited partnership; yet it obtains the same results as a limited partnership, without statutory authorization. Accordingly, the "partnership" with the trust would seem to be unentitled to recognition as any type of partnership. If, however, the trustee is to be personally liable, there would seem to be no conflict with any strong State public policy in recognizing the partnership.

Judicial Rulings

The various cases from which a practitioner can draw do not seem to indicate what recognition tax-wise will be accorded to partnerships with trusts. In an early Board of Tax Appeals case,[23] it was held that in the absence of any evidence of bad faith, a partnership agreement may include a trustee as one of the partners, and income allocable to the trust will not be taxable to the settlor-partners.

In *Thomas v. Feldman*,[24] where taxpayers transferred to a trust created by them for the benefit of their children certain shares of stock in two family corporations, dissolved the corporations, and had the assets thereof distributed to the respective shareholders, who organized two limited partnerships, with one of the taxpayers as general and managing partner, the trust and other partners being limited partners, partnership income allocated to the trust was held not taxable to the taxpayers.

In a 1949 case,[25] there is the statement that whether ". . trusts were *bona fide* members of a partnership must be determined by their agreement considered as a whole and their conduct in execution of its provisions." It was held that there was substantial evidence to sustain the verdict that the trusts were *bona fide* members of a partnership organized for business purposes.

A decision by a Federal District Court of Iowa last summer has provided an interesting addition to the picture. In *Hanson v. Birmingham*,[26] a father sued for a refund of taxes assessed against him on income that had been received by a trust for his children. The *trust*, rather than the trustee or the beneficiaries, had been made a partner in his business. It was held that the trust was not a *bona fide* partner under Iowa partnership law, notwithstanding authorization in the trust instrument. The Court said that a trust was not qualified to assume partnership status; therefore, it was not entitled to recognition as a partner for income tax purposes.

Judge Graven exhaustively reviewed the authorities from both the common law and the tax standpoint. Considerable reliance was placed upon the fact that none of the

[22] See, *e.g.*, Commissioner v. Barnes, 30 F.2d 289 (3d Cir. 1929).
[23] *Reeb*, 8 B.T.A. 759 (1927).
[24] 158 F.2d 488 (5th Cir. 1946).
[25] Thompson v. Riggs, *supra* note 21.
[26] 92 F. Supp. 33 (N.D. Iowa, 1950).

leading trust authorities mention the possibility of a trust being a member of a partnership. "The reason for such paucity of authority on the question could be that it was generally assumed that it would be incompatible and inconsistent with and alien to common law concepts for a trust to be a partner."[27]

On the applicability or inapplicability of State law in partnership cases under the Federal Income Tax, the Court stated that there has been no clearcut ruling by the Supreme Court on the question of whether a partnership, invalid under State law would be upheld for purposes of the income tax. However, after a comprehensive examination of the tax cases, Judge Graven concluded that: "There is no indication in the decisions of the United States Supreme Court that it intended that a type of partnership relation unknown to any field of the common law should be given recognition for Federal Income Tax purposes."

Of more substantial import for the taxpayers are the ideas of the Tax Court. On the point under discussion, a late decision squarely rejects Judge Graven's holding that a trust cannot as a matter of law be a member of a partnership.

In *(Matter of) Stern,*[28] the Tax Court held that a trust was a valid partner in a family business, preliminarily deciding that nothing in substantive law prevents a trust from being a partner in a business. It specifically rejected the *Hanson* case, and further said that IRC § 3797 (a) (2), serves te validate a partnership for tax purposes even though it may be illegal under local law. Five Tax Court judges dissented from the result. Whether this dissent was on the common law ground that a trust cannot be a partner at all, or on the tax ground that the trusts were not partners for tax purposes, does not appear.

It is not clear from the cases whether the Commissioner is going to pursue the *Hanson* argument and result in order to knock out trusts as partners in family businesses. Regardless of how the Commissioner will attack the problem

[27] *Id.* at 45.
[28] 15 T.C. No. 71.

and regardless of the basic legality or illegality of a trust as a partner, the taxpayer will encounter considerable difficulty in establishing that his trust is not an obvious tax avoidanco scheme.

Conclusions

In order for a partnership with a trust to function effectively tax wise it would seem that the tax payer who seeks to sustain the partnership would have to establish (1) that under local law there is a valid partnership or some similar arrangement by which the trust is legally entitled to a share of the partnership profits, and (2) that the partnership was formed for a *bona fide* business purpose and not merely to avoid taxes.

The difficulty in establishing these points may well dissuade tax payers from undertaking such arrangements, at least until their status is more clearly defined. On the other hand, these arrangements seem little more subject to question than some other income-splitting devices, such as the transfer of capital or property and its lease or loan back to the grantor.[29] Perhaps the only clear way out is the use of the family corporation; but with that device the incurring of corporation taxes reduces the gratification of the evasive tax payer.

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[29] See Note, 59 *Yale L. J.* 1529 (1950).