

## Taxation: Family Partnerships

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This language is frequently quoted by writers on the subject. The Wisconsin Supreme Court used substantially this same standard in *Thauer v. Gaebler*,<sup>8</sup> decided a few years before *Rogers v. Hill*. This was a derivative action by minority stockholders to recover a bonus of \$500 to an officer for services performed during a preceding year, and to enjoin an increase in salary voted by the board of directors for two of its officers. The Court stated:

"There must be a clear abuse of discretion, fraud, or bad faith, resulting in spoliation of minority stockholders and ruin to the corporation."<sup>9</sup>

It is implicit in the case that on any strong appeal for relief the court might hold director action to be an abuse of discretion as a matter of law. It should be further noted that this whole question is a matter regulated by decisional law. The writer could find no statute applicable to the situation in the instant case.

FREDERICK A. MILLER

**Taxation — Family Partnerships** — Upon the dissolution of the Coon-Culbertson cattle raising partnership taxpayer Culbertson bought up the basic stock with the understanding that his sons be taken into the new business. A new partnership was formed by Culbertson and his four sons. The sons' contributed share of the capital was represented by their note, payment of which was made partly with funds received as a gift from the taxpayer and partly by proceeds of a loan procured from the new partnership. The oldest son rendered some service, although not vital in nature, to the conduct of the partnership before being called to army service. The other sons rendered no service because of either college or army demands for their time, although it was their intention eventually to become active in the business. The taxpayer distributed the profits according to the partnership agreement and included only his distributive share in his federal income tax return. The Tax Court included the entire partnership income in the father's return, holding that the sons did not contribute "vital services" or "original capital" and insisting that these objective tests must be met to establish the existence of a partnership for tax purposes.<sup>1</sup> The Circuit Court of Appeals reversed on a finding of intention to form a partnership and to render future service to it.<sup>2</sup> *Held*: reversed. Both courts handed down decisions based on falacious interpretation of established precedent. The case was remanded to the Tax Court for re-

<sup>8</sup> 202 Wis. 296, 232, N.W. 561 (1930); noted in 1939 WIS. L. REV. 221; 164 A.L.R. 1133; 175 A.L.R. 594.

<sup>9</sup> 202 Wis. 296, 302, 232 N.W. 561, 564 (1930).

<sup>1</sup> ¶ 47,168 P-H MEMO T.C. (1947).

<sup>2</sup> 168 F(2d) 980 (1948).

consideration in conformity with principles laid down in the opinion. *Commissioner of Internal Revenue v. W. O. Culbertson, Sr., and Gladys Culbertson*, 5 P-H 1949 *Fed. Tax Serv.* ¶ 72,012 (U.S. #313 1949).

The established precedent referred to is found in the *Tower*<sup>3</sup> and *Lusthaus*<sup>4</sup> cases. It was from the following statement in the *Tower* opinion that the Tax Court took the above mentioned tests:

“There can be no question that a wife and a husband may, under certain circumstances, become partners for tax, as for other, purposes. If she either invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital services, or does all these things she may be a partner as contemplated by 26 U.S.C. Secs. 181, 182 . . . But when she does not share in the management and control of the business, contributes no vital additional service, and where the husband purports in some way to have given her a partnership interest, the Tax Court may properly take these circumstances into consideration in determining whether the partnership is real within the meaning of the federal revenue laws.”

In the instant case the Supreme Court charged the Tax Court with “error in emphasis.” The use of objective tests was deplored and good faith intention (n.b. subjectivity) to form a partnership was said to be decisive. The Supreme Court thus reverted back to the concept of partnership as laid down in *Meehan v. Valentine*.<sup>5</sup> Their understanding was reiterated in the following rule:

“If upon a consideration of all the facts, it is found that the partners joined together in good faith to conduct a business having agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits, that is sufficient.”

This subjective test would allow a family member to contribute non-originating capital without affecting his partnership status provided that such contributing member maintains a sufficient measure of control over the employment of that capital.

The chastisement of the Tax Court was not the sole reprimand in the present case. The Circuit Court was admonished thusly: labor and/or capital produce income. If neither labor nor capital come from an intended partner, he cannot be said to have earned income tax-wise. He is not “carrying on business as a partner” within the meaning of

<sup>3</sup> *Commissioner v. Tower*, 327 U.S. 280 (1946).

<sup>4</sup> *Lusthaus v. Commissioner*, 327 U.S. 293 (1946).

<sup>5</sup> 145 U.S. 611 (1892) where the following essential requirements for partnership were listed: 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.

section 181. The labor or capital, subject to exceptions not here important, must be *presently*<sup>6</sup> participating in order to have income presently earned by a partner. Where the Tax Court was too strict in the recognition of "partnership", the Circuit Court was too lax.

The Supreme Court has specifically reserved the question of whether the profits of the partnership can be reallocated despite the partnership agreement. Sections 181, 182 of the Internal Revenue Code provide that the income of a partnership is to be taxed only to the partners in their individual capacity, according to their distributive share. What is considered the distributive share is not mentioned. As to family partnerships,<sup>7</sup> the Commissioner<sup>8</sup> and the Tax Court<sup>9</sup> have developed what is known as the allocation theory; namely, that partnership profits be allocated to members in the same proportion as the services and capital employed to produce those profits are traceable to them. Profit ratios of the partnership agreement are ignored. This device puts into the partnership field the same concepts developed with respect to section 22(a) by *Lucas v. Earl*<sup>10</sup> and the *Blair*<sup>11</sup> case; that income must be taxed to its source. If the Commissioner has the right to allocate the profits on this formula, which apparently he has, it is assured that the government will suffer no loss of revenues whether or not an assembly of family members can be shown to be a true partnership. It may be, therefore, that the Tax Court has been unduly concerned with the reality of the partnership entity when composed of members of the immediate family. Certainly, their anxiety to defeat the partnership in the first instance has raised havoc with the concept of partnership. The instant case, however, corrects their course. This case, although making no progress in the determination of the incident of taxation, has reestablished the position of the concept "partnership" in our tax law.

HOWARD H. BOYLE, JR.

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<sup>6</sup> By requiring *present* employment of capital or services the Supreme Court has established an objective test. But see the concurring opinion of Mr. Justice Burton, "A present commitment to render future services to a partnership is in itself a material consideration to be weighed with all other material considerations."

<sup>7</sup> "The usual type of family partnership 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. The profits are thus taxed to two or more individuals, rather than to the taxpayer alone." Barkan, *Family Partnership Under the Income Tax*, 44 MICH. L. REV. 179 (1945).

<sup>8</sup> I.T. 3845 (1947).

<sup>9</sup> *Canfield v. Commissioner*, 7 T.C. 944 (1946).

<sup>10</sup> 281 U.S. 111 (1930).

<sup>11</sup> *Blair v. Commissioner*, 300 U.S. 5 (1937).