Federal Taxation: Evidentiary Requirements of a Valid Family Partnership

Norman Wegner

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COMMENTS

TAXATION—EVIDENTIARY REQUIREMENTS OF A VALID FAMILY PARTNERSHIP

Recent developments in the taxation of the income of family partnerships makes it essential to reexamine the evidentiary tests being currently applied to determine how the partners are taxed. The Wisconsin attorney must be aware of Federal developments in this field because the Wisconsin Supreme Court has recently accepted the precepts of the celebrated Tower case\(^1\) for State income tax purposes. Thus both Federal and State income tax questions in this field will generally follow the same criteria of taxability.

The problem arises typically in those cases where a husband and wife, or other member of the family, are members of a partnership, the income from which is split between them and reported by each as his or her own. Major emphasis will be placed on the husband and wife type of family partnership in this analysis.

In the Tower case,\(^2\) the Supreme Court made it clear that one or more of the following must be present in order to provide a basis for a valid family partnership as far as Federal income tax purposes are concerned: the capital which the wife invests must originate with her or else she must substantially contribute to the control and management of the business, or otherwise perform vital additional services.\(^3\)

Following this, in I.T. 3845\(^4\) and in the Canfield case,\(^5\) the Commissioner and the Tax Court clarified and amplified the above tests. In

\(^1\) Thomas v. Wisconsin, 250 Wis. 8 (1947).
\(^3\) The facts showed that the wife performed no services in the partnership business and the capital contribution which she made consisted of assets given to her as a gift by her husband three days before the formation of the partnership.
\(^5\) I.T. 3845, P.H. Par. 76, 153 (1947.). In this I.T. the Bureau's policy with respect to so-called family partnerships was set forth. The three tests of the Tower case and the one additional test of the Canfield case are to be applied to the facts of each case as it arises, so that family partnerships will be divided into three broad classes for income tax purposes: (1) Bona fide partnerships, (2) Sham transactions and tax-avoidance schemes, (3) Intermediate cases. In cases within this last group the profits will be allocated, as between income attributable to personal services and income attributable to capital. The amount of the profits attributable to services will be apportioned between the parties on the basis of the fair value of the services actually rendered by each party. Then the amount of the profits attributable to capital will be apportioned between the parties on the basis of the capital and credit (necessary for the business) originating with, and risked by, each party.

\(^6\) Canfield v. Commissioner, 7 T.C. 944 (1946). In this case the problem arose as to what happens when the partnership agreement is bona fide and the Tower tests are met, but the percentage division of profits between the partners is out of proportion to the original capital contributions made or the services rendered by the partners. The Tax Court found that 75 per cent of the income of the partnership was attributable to services rendered and the remaining 25
correlating the many rules which have been set up and applied since the *Tower* case, it seems that the basic factors to be considered in determining the effectiveness, for income tax purposes, of an agreement purporting to create a family partnership, can be reduced to six in number:

1. Capital or credit contribution.
2. Rendition of vital services.
3. Control and management of business.
4. Reasonableness of profit division.
5. Business purpose.
6. Use of profits.

The first three listed are derived directly from the *Tower* case itself, while the fourth comes from the opinion in the *Canfield* case.

1. **Capital or credit contribution.** The contribution to the business, subject to its risks, of capital or credit originating with the contributor, which capital or credit is needed for and was not already available to the business is basic. Where the wife renders no substantial managerial or other vital services, so that the recognition of the partnership depends primarily upon her contribution of capital, attention will be given to the source and nature of her contribution. The wife's contribution should come from her own separate estate or from a gift remote enough in point of time to avoid any connection with the acquisition of her interest in the partnership. Even when several years have passed between the date of the gift and the wife's acquisition of her interest, the courts have refused to recognize it as being her own original capital contribution. Merely because the gift of money, property or an interest in the partnership was valid and a gift tax was paid upon it, such a transfer does not automatically require recognition of the arrangement. Any gift which is incomplete or conditional on its being used to acquire a share in an existing or future partnership will, of course, be considered as evidence against the taxpayer. In addition, the courts will observe whether or not the partner-

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ship interest received by the wife is alienable by her, or was transferred to her upon condition that she make a will for the return, upon her death, of such interest to the transferor. The fact that a capital account for the wife was not set up is not conclusive, but the failure to do so is a circumstance tending to show an invalid partnership. Where the capital contribution consists of notes to be satisfied out of later profits and no vital services are performed, the partnership will usually not be recognized.

In *Durwood v. Commissioner,* the Tax Court held that the rule of the *Tower* case did not apply because no tax avoidance was effected since the interest of the new partner, the wife, was acquired from the husband's old partners, his brothers, and not from him. This result was reached even though the husband had made it possible for his wife to secure the money with which to purchase the interest. A similar result was reached where the wife purchased an uncle's one-fourth interest. However, receipt of the interest from a third party does not always provide assurance of recognition. In *Nordling v. Commissioner,* the wife performed no services, and she acquired her interest in the partnership from her husband's brother, a former partner. She paid for the share with money given to her as a gift by her husband. The court held that 'reality' should be given effect since the wife was only a nominal participant and the capital did not originate with her. Where personal services did not contribute to the organization's income, which was attributable entirely to the capital invested in an 'investment pool', the partnership was upheld even though the stock contributed by the wife was given to her by the husband a few months before when no partnership had been contemplated. No showing was made that the gift was conditional. In *Shulak v. Commissioner,* the partnership was upheld where the wife bought the interests of her husband's former partners with her own funds. If the wife has loaned money to her husband some years before the partnership is formed, the taxpayer must be able to prove that the loan was made in consideration of a transfer of an interest to the wife in order to justify income-splitting. When the wife renders valuable services, the fact that she received her interest as a gift will not defeat the partnership.

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10 Belcher v. Commissioner, 7 T.C. 182 (1947).
11 Schepps v. Arnold, P.H. Par. 72, 514 (1947).
12 Durwood v. Commissioner, 159 F. (2d) 400 (1947).
13 Alexander, 6 T.C. 804 (1946).
15 Rosborough, 8 T.C. 136 (1947).
(2) **Rendition of vital services.** The alleged partner must perform services, in the regular conduct of the business, to a degree and of a quality commensurate with the status of a partner in that kind of business. It is not sufficient that the wife render some personal services in connection with the business where they are not necessary or are not connected with management. Mere clerical services are not enough.\(^19\) Thus, where a wife answered the phone in a home office, handled invoices, and collected rents, the services were held not vital or essential or of a managerial nature.\(^20\) No new capital need be contributed by the wife where she does render such valuable services.\(^21\) When the wife is prevented from continuing to perform essential services due to the birth of a child, the partnership does not become invalid.\(^22\) If the wife’s services are not shown to be essential and she does receive a salary for her work, the amounts received as wages are deemed to be sufficient compensation and the partnership will be disregarded.\(^23\) In *Knott v. Allen*, \(^24\) where the family partnership operated a business college, vital services by the wife were presumed; however, usually no such presumption is made. If the wife performs services of the same character and of equal importance as those of the husband, the arrangement will be held to be bona fide for tax purposes.\(^25\) It is easy to see that a family partnership in connection with the operation of a personal service business will be recognized only where all members actually render such services.\(^26\)

(3) **Control and management of business.** Also considered will be the nature and extent of the alleged partner’s participation in the control and management of the business.\(^27\) Anything less than an actual managerial position involving substantial participation commensurate with the income received will receive scant consideration.\(^28\) The power to write checks should be given to both parties.\(^29\) Where only one bank account is maintained and the husband has sole control over it, the partnership may be held invalid.\(^30\) If the wife has no real share in the control and management and does not have a voice in the business policies to be followed, the court will ignore the paper organization and


\(^{20}\) Sandburg, 8 T.C. 423 (1947).

\(^{21}\) Marks, 6 T.C. 659 (1946); Parker, 6 T.C. 974 (1946).

\(^{22}\) Singletary v. Commissioner, 155 F.2d 207 (1946).


\(^{24}\) Knott v. Allen, P.H. Par. 72, 414 (1947).


\(^{26}\) Harvey, 6 T.C. 653 (1946).

\(^{27}\) I.T. 3845, P.H. Par. 76, 153 (1947).

\(^{28}\) “Family Partnerships,” 41 Ill. L. Rev. 669 (1947).

\(^{29}\) Schreiber v. Commissioner, 160 F.(d) 108 (1947); Marks, 6 T.C. 659 (1946).

tax the entire income to the husband. Where the instrument purporting to create the family partnership expressly provides that the wife or other member of the family shall not be required to participate in the management of the business, or is merely silent on that point, the extent and nature of the services of such individual in the actual conduct of the business will be given appropriate evidentiary weight as to the question of intent to carry on the business as partners.

(4) Reasonableness of profit division. The facts must show the reasonableness of the relation between the proportionate share of the profits granted to any one member of the family by the agreement and the proportion of the earnings which is fairly attributable to the services rendered by, or the contributed capital originating with said member. The Canfield case was an effective effort to plug a loophole in the rule of the Tower case. Previously, if the Tower tests were met, the profit division as set forth in the partnership agreement had to be upheld. With the decision in the Canfield case, another element must now be proved in order to pass the Commissioner's challenge, namely, is the profit division agreement reasonable, apart from the capital contribution or services test? The courts will not be bound by the terms of the partnership agreement as to profit division even where it is held to be bona fide. Income will be taxed to the person who earns it.

(5) Business purpose. The fact that no business purpose is served by the admission of the wife as a partner in conducting the business indicates that it will probably not be recognized. The courts will also inquire whether the arrangement is between the head of the family and members of his family to whom he owes the obligation of support, and the dominant purpose of the scheme is merely to provide such support and at the same time to divide the income tax consequences among such members of his family. This will include an inquiry as to whether large profits were being presently realized or shortly to be anticipated by the head of the family. The agreement setting up the family partnership need not be in writing. In order to show that the agreement is bona fide, whether oral or written, it is best to file informational tax returns for the partnership showing the

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32 Pritchard, 7 T.C. 1223 (1946).
33 Canfield v. Commissioner, 7 T.C. 944 (1946); Argo v. Commissioner, 3 T.C. 1120; Todd v. Commissioner, 7 T.C. 399.
35 Tinkoff v. Commissioner, 120 F.(2d) 564 (1941).
amount of profits and the proportionate share or interest held by each member of the firm. A strong dissent in a decision upholding a challenged family partnership was based on the fact that previous years' state and federal tax returns and also the social security returns had been made out in the husband's name alone. When a family member is added to a partnership, it is important that sufficient notice of the change be given to all outsiders doing business with the firm. However, absence of public notoriety will not defeat an otherwise valid partnership. Definite agreement to share profits should be made because if there is no such agreement, or the practice is not to share profits, the partnership will not be recognized. Absence of an agreement to share losses is not conclusive since such an agreement is implied if all of the other elements of a valid partnership are present. An attempt to fulfill the business purpose requirement may fail when the taxpayer is unable to show any change in the operation or management of the business after the new partner was admitted. Merely having the wife hold the bare legal title to tangible assets is insufficient. However, conducting the business or holding the property in the husband's name is immaterial if the wife fulfills the requirements as to capital contribution or the rendition of services. Proof of a motive to reduce taxes by the partnership arrangement lends strength to the inference that there was no real partnership intended. Of course, if it can be proved that the arrangement was begun years before with no thought of future income tax liability, it will be considered strong evidence of the absence of an intent to escape such tax liability.

(6) Use of profits. If the wife pays household or family expenses out of her share of the profits, that is considered a factor which militates against the partnership. The profits which the wife receives should be placed in a separate bank account in her name and for her own personal use. She might use the money to pay the premiums on policies of insurance on her husband's life, making herself and the children beneficiaries. This will save some estate tax as well. However, if the other requirements are met, the fact that the wife uses

40 Akers, 6 T.C. 693 (1946).
43 Appel v. Smith, 161 F.(2d) 122 (1947); Pritchard, 7 T.C. 1228 (1946).
45 Fletcher, 7 T.C. 1186 (1946).
48 Anderson, 6 T.C. 964 (1946).
her share to pay household expenses does not destroy the genuineness of the partnership.\(^{50}\)

In summary, only two things produce partnership income: capital and services. Therefore, the reasonableness of the profit division, based upon the relative amounts of capital and services contributed by each member, stands over and above all other factors. The courts must be satisfied as to this requirement regardless of how close to the borderline of invalidity the arrangement stands otherwise. Fulfilling the requirement as to capital or credit contribution alone will be enough provided that the source of such contribution cannot be traced back directly to the husband and unless the partnership income is earned principally by means of personal services. Where the wife does render vital services or participate actively in the control and management of the business, the chances that the arrangement will be upheld are excellent, regardless of whether a capital contribution is made, provided such services are necessary in the type of business involved. The showing of a valid business purpose or of a use of profits, by the wife, which indicates a separate estate are factors which, in themselves, are not enough to uphold a partnership. However, the presence or absence of such evidentiary facts would probably act as weights in cases where a considerable degree of doubt existed.

The location of the line beyond which family partnerships should not be recognized for Federal income tax purposes is a most difficult problem.\(^{51}\) This line is basically artificial and will remain confusing until its elimination by the adoption of a Federal tax law which requires a compulsory joint return for husband, wife and minor children who are members of the immediate family.

Norman W. Wegner

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\(^{50}\) Kille, TC Memo. Dec. P.H. Par. 47,217 (1947).