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TAXATION-INCOME TAX-VALIDITY OF FAMILY PARTNERSHIP WHERE PARTNER'S SERVICES ARE TO BE PERFORMED IN FUTURE

Daniel W. Reddin, III S.Ed.
University of Michigan Law School

TAXATION—INCOME TAX—VALIDITY OF FAMILY PARTNERSHIP WHERE PARTNER'S SERVICES ARE TO BE PERFORMED IN FUTURE—In 1939, petitioner sold certain ranch properties and half of his herd of blooded cattle to his four sons, accepting their notes in return. A firm consisting of petitioner and his sons was then formed, and a bank account was opened upon which any of the members of the firm could draw. Two of the sons were minors, but all were ranch-reared and experienced in cattle raising. The sons paid part of the notes with their shares in the proceeds from firm sales, and petitioner forgave the rest. Military duty disrupted the plan by which all the sons were to work on the ranch, and at the time of the hearing only two had rendered services in the partnership enterprise. The firm filed a partnership return for 1940. The Commissioner determined a deficiency against the petitioner for that year, attributing all the income of the firm to him. The Tax Court[1] held that the firm was not a partnership for tax purposes, since the capital contributed did not "originate" with the sons and the services rendered by them were not "vital," in the sense required by the *Tower* and *Lusthaus* decisions.[2] On appeal, *held*, reversed. Where it is contemplated that a family member will contribute capital or "vital" services, they may be forthcoming either presently or at some future time. *Culbertson v. Commissioner*, (C.C.A. 5th, 1948) 168 F. (2d) 979.

In determining the tax-validity of family partnerships,[3] the lower courts are confronted with two competing principles developed by the Supreme Court; namely, that tax liability cannot be avoided by the assignment of future income from personal services,[4] and that tax liability can be shifted by a gift of income-producing property.[5] Originally, the first of these principles was applied when the court determined that the management of the business by the taxpayer and not the contribution of capital by family members was the predominant factor in the production of the firm income; the second principle was followed where the reverse situation existed.[6] This method of approach was altered, however, by the decisions in the *Tower* and *Lusthaus* cases,[7] which indicated that no family partnership

[1] W. O. Culbertson, Sr., 1947 P.H. TAX CT. MEMO. DEC. ¶ 47,168.

[2] Commissioner v. Tower, 327 U.S. 280, 66 S.Ct. 532 (1946); Lusthaus v. Commissioner, 327 U.S. 293, 66 S.Ct. 539 (1946).

[3] Though the income splitting provisions of the 1948 Revenue Act, H.R. 4790, May 1, 1948 (Public Law No. 471), will lessen the importance of the husband-wife partnership as a tax evading device, formation of partnerships involving other members of the family will still be useful.

[4] Lucas v. Earl, 281 U.S. 111, 50 S.Ct. 241 (1930); see also Burnet v. Leininger, 285 U.S. 136, 52 S.Ct. 345 (1932).

[5] Blair v. Commissioner, 300 U.S. 5, 57 S.Ct. 330 (1937). See also Alexandre, "The Corporate Counterpart of the Family Partnership," 2 TAX LAW REV. 493 (1947).

[6] Partnership upheld: J. D. Johnston, Jr., 3 T.C. 799 (1944); M. W. Smith, 3 T.C. 894 (1944). Partnership denied: Earp v. Jones, (C.C.A. 10th, 1942) 131 F. (2d) 292, cert. den. 318 U.S. 764, 63 S.Ct. 665 (1943); Mead v. Commissioner, (C.C.A. 5th, 1942) 131 F. (2d) 323, cert. den. 318 U.S. 777, 63 S.Ct. 851 (1943); Schroeder v. Commissioner, (C.C.A. 5th, 1943) 134 F. (2d) 346.

[7] Supra, note 2.

would be recognized for tax purposes except upon a showing that it was formed in good faith to carry on business as a partnership and not as a mere device for tax minimization.[8] Investment of capital "originating" with the family member, substantial contribution to the management and control of the business, or performance of "vital" services were alternative tests which would justify the inference that the partnership was genuine.[9] Following these decisions, an overwhelming number of the family partnership arrangements litigated were found inadequate for tax purposes.[10] In 1947, however, the Tax Court upheld a partnership where the wife contributed corporate stock which her husband had previously given her, because the gift had not been made as part of a preconceived plan to form a partnership.[11] Since that decision, the requirement of capital "originating" with the family member has been less difficult to meet. The principal case, if upheld, will further simplify meeting the *Tower-Lusthaus* test by allowing formation of tax-valid partnerships in which the services are to be contributed in the future. Though it is clear that the partnership here recognized was formed in good faith to engage in business, it would seem that this new alternative test for tax validity, when applied to other situations, may lead to recognition of partnerships formed solely for avoidance.

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[8] 327 U.S. 280 at 289, 66 S.Ct. 532 (1946).

[9] Id. at 290. After the Tower decision, the Tax Court, in Claire L. Canfield, 7 T.C. 944 (1946), disregarded provisions contained in partnership articles relating to the proportion of firm profits to be received by the wife, allocating to her instead that portion of the firm income which it thought might be attributed to her contribution of original capital. For a discussion of the allocation principle, see Robinson, "The Allocation Theory in Family Partnership Cases," 25 TAXES 963 (1947).

[10] For a case annotation, see Sizer, "Federal Income Tax Treatment of Family Partnerships Since Tower and Lusthaus Cases," WIS. L. REV. 293 (1947).

[11] S. E. Boozer, 1947 P-H TAX CT. MEMO. DEC. ¶ 47,248; noted in 46 MICH. L. REV. 703 (1948).