Family Partnerships and the Federal Income Tax

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NOTES

FAMILY PARTNERSHIPS AND THE FEDERAL INCOME TAX

I. INTRODUCTION

In this period of heavy income tax burdens, the quest for a means whereby income may be redirected, commonly referred to as income-splitting, has assumed great importance. This discussion concerns one such device for redirecting income—the family partnership. Whether a family partnership is the proper device in a given situation is not considered. A review of the present state of federal income tax law regarding the validity of family partnerships is the sole aim.

Individuals carrying on a business enterprise in partnership form are taxed only in their individual capacity, upon their distributive share of the partnership's income. The partnership itself is not taxed as a separate entity, but is merely required to file an information return (Form 1065) which discloses the amount of distributive shares of income, gain, loss, deduction, or credit allocated to each partner.

Because partnership income is taxed only to the individual partners, accompanied by the progressive tax rate structure, income-splitting among members of a family partnership recognized for federal income tax purposes results in a tax saving to the family unit. The greater the number of individuals or entities among which a given amount of income is divided, the lower will be the average tax rate applicable and, consequently, the lower the total tax liability on the income.

The war years marked a rise in popularity of the family partnership as an income-splitting device. Wartime increases in individual tax rates, corporate income tax rates, and excess profits tax rates spotlighted the tax advantages of using the family partnership to split income, thereby retaining a larger amount of income in the family group.

Intra-family arrangements and transactions have always been closely scrutinized to ascertain whether the transaction has substance as well as

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1. INT. REV. CODE OF 1954, § 701.
3. See Mauritz v. Scofield, 206 F.2d 135 (5th Cir. 1953) (three brothers spread 60% of their business interests among ten trusts for their children, nieces, nephews, and unmarried sisters. In fourteen years over $700,000 was shifted to 29 taxpayers).
4. Between 1939 and 1941 there were approximately 290,000 family partnerships in America. By 1948, this number had grown to 930,000. 97 Cong. Rec. 12147 (daily ed. Sept. 26, 1951).
form since opportunities abound for agreements between family members to be subverted to tax avoidance purposes. Family partnerships operate under this general suspicion because the close kinship and mutual interest of the purported partners create a tempting opportunity for the family group to attempt to secure tax advantages by income-splitting through the operation of a profitable business enterprise in the outward form of a partnership, although it is not actually such in substance.

The joint return provisions added to the Code in 1948, whereby husband and wife are permitted to split income by filing joint returns, removed most of the tax-attractiveness of the family partnership device for husband and wife. However, family members other than husband or wife can also be recognized as partners; for instance, minor children and elder parents. It is in this context that the family partnership remains a source of tax benefits.

The all-important inquiry is, under what conditions will a family partnership be recognized for federal income tax purposes? By way of preliminary precaution, it must be noted that there are no hard and fast rules which, if followed, will ensure the desired results. To search for certainty where none in fact exists is at best a fruitless endeavor. The most that one can do is to be aware of the pertinent factors in determining validity and be certain that no pertinent factor is left unweighed.

II. DEVELOPMENT OF THE LAW OF FAMILY PARTNERSHIPS

The family partnership device is only one of a wide-ranging group of income-splitting devices. Reference must be made, therefore, to two enduring principles of taxation applicable to all income-splitting devices:

7. While a married couple will rarely find any advantage in filing separate returns because of the split income possibility, there are some notable exceptions where the filing of separate returns may be advantageous tax-wise. For instance, the use of separate returns permits both husband and wife to each use $1000 of capital loss against ordinary income, whereas in a joint return, § 1211(b) limits the aggregate deduction to only $1000. Also, in the case where one spouse has paid substantial medical expenses during the taxable year, separate returns will reduce the "adjusted gross income" of the one who paid the medical expenses and will result in a larger medical deduction. Finally, § 151(e)(2) prevents either party to a joint return from being claimed as a dependent by a third taxpayer. Thus, it may be preferable for some low-bracket taxpayers to file separate returns, for instance, a married student who is supported by his father and whose wife's adjusted gross income is $2000. Under the tax table of § 3 the tax on a separate return on this amount is $175, on a joint return, $58. By filing a separate return and paying the higher tax, the father may receive a deduction for the son as a dependent which is more valuable to the family unit because of the higher tax rate of the father.

8. For a summary of these income-splitting devices and their development, see Hearings Before the House Committee on Ways and Means on Revenue Revisions, 1947-48, 80th Cong., 1st Sess. 866-74 (1947).
(1) income attributable to personal services is taxable to the person whose personal service earned it, and (2) income attributable to property is taxable to the person who owns the property. It is against the background of these rules that the law of family partnerships has developed.

There are three landmarks—two judicial and one legislative—which have been most important in shaping the law of family partnerships. The family partnership device was before the Supreme Court for the first time in 1946 in the companion cases of *Commissioner v. Tower* and *Lusthaus v. Commissioner.* Three years later the Court reconsidered the family partnership device in *Commissioner v. Culbertson.* Finally, Congress, being somewhat dissatisfied with certain aspects of the existing state of family partnership law, gave its attention to the problem, culminating in amendments to the 1939 Code.

A. *The Law Prior to 1951: Tower, Lusthaus, and Culbertson.*

The increased popularity of the family partnership, due largely to higher wartime tax rates, was accompanied by increased tax litigation involving family partnerships. These decisions reveal a considerable diversity of judicial opinion concerning the legal principles controlling the use of the family partnership for tax purposes. To resolve some of the confusion, the Supreme Court, in 1946, agreed to give a full examination to the subject by hearing the companion *Tower* and *Lusthaus* cases. The relevant facts in these cases were substantially the same: a husband made a gift of capital to his wife and the donated capital was sought to be made the basis of a partnership interest. Yet, the lower courts in deciding the two cases reached opposite results. The Court of Appeals for the Sixth Circuit held in the *Tower* case that the partnership should be

15. For an indication of the increased litigation, see the tables and cases cited in *Hearings Before the House Committee on Ways and Means on Revenue Revision, 1947-48, 80th Cong., 1st Sess. 945-46 (1947).*
17. 327 U.S. at 284.
18. Mr. Lusthaus gave his wife money which she used, together with personal notes given to Mr. Lusthaus, to purchase an interest in the partnership. There was an informal understanding that she would pay off the notes out of her share of the partnership income. Mr. Tower gave his wife shares in his controlled corporation pursuant to a plan whereby the corporation was thereafter dissolved and Mrs. Tower contributed her share of corporate assets to the partnership in exchange for a limited partnership interest.
19. 148 F.2d 388 (6th Cir. 1945).
recognized for tax purposes, but the Court of Appeals for the Third Circuit denied recognition of the partnership in the *Lusthaus* case. The Supreme Court held that neither partnership was entitled to recognition.

Thus, for the first time, the Supreme Court had considered the family partnership problem and its opinions in the *Tower* and *Lusthaus* cases were closely scrutinized for rules which, if faithfully adhered to, would guarantee satisfactory results. Many courts and writers seized upon the following portion of Mr. Justice Black's opinion in the *Tower* case as the ratio decidendi of the 1946 decision:

... 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 additional services ... she may be a partner....

Hence, the approach to the family partnership problem, after the *Tower* and *Lusthaus* decisions, was an inquiry into whether a purported partner had contributed either of the essential elements to the partnership, i.e., "vital services" or "original capital" (capital originating with the questioned partner as opposed to capital acquired by gift from another member of the partnership). Thus, in the absence of participation in the management and control of the business or performance of other vital services, this approach precluded the possibility of using capital which had been the subject matter of a gift from another family member or using a gift of a share of partnership assets as the sole basis of a partnership interest recognizable for tax purposes.

The Commissioner consistently took the position that "gift capital"
could not be a valid basis for an interest in a family partnership, and the objective tests, requiring a contribution of either “vital services” or “original capital,” continued to constitute the applicable family partnership law until 1949. In that year the Supreme Court agreed to hear the Culbertson case to give “further consideration [to] the family partnership problem.”

In Culbertson the taxpayer’s four sons had acquired partnership interests in a cattle business by giving their father their note. This note was subsequently satisfied in part by a gift from the father and in part by proceeds of the partnership operation. During the tax years in question, one son was in military service and two others were in school during the winter months, working on the ranch only in the summer. The Tax Court found that none of the sons had contributed “vital or management services” or “original capital” to the business. The court acknowledged that the presence of either of these elements was “deemed by the Tower case essential to family partnership recognition for federal tax purposes” and refused to recognize the partnership for tax purposes. Thus, the entire income from the cattle operations was taxed to the father. The Court of Appeals for the Fifth Circuit reversed the Tax Court and the Commissioner carried the case to the Supreme Court. Thus, for a second time the family partnership problem was before the Supreme Court.

The Court held that the Tower decision had been misinterpreted by considering a contribution of either “vital services” or “original capital” as an essential requirement for membership in a family partnership. The Court said that the real question was “whether, considering all the facts . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.” The Culbertson decision thus replaced the objective standards of “vital services” and “original capital” with a subjective inquiry into the intent with which the parties had acted, this requisite intent to be gathered from objective manifestations. The Court, however, disclaimed any intention of modifying or limiting its decision in the Tower case and pointed to the neglected portion of the Tower opinion which set out the proper test of validity:

When the existence of an alleged partnership arrangement is challenged . . . the question arises whether the partners really and truly intended to join together for the purpose of carrying

26. 337 U.S. at 735.
28. Id. at 603.
29. 337 U.S. at 742.
on business and sharing in the profits or losses . . . [and] we see no reason why this general rule should not apply . . . where the government challenges the existence of a partnership for tax purposes.  

Contribution of "original capital" or "vital services" was relegated to evidentiary status by the Culbertson decision and henceforth was to be considered along with other evidence of intent.  

A most important aspect of the Culbertson decision was the Court's careful attention to "gift capital." The Court pointed out that the Tower decision "did not say that the donee of an intra-family gift could never become a partner through investment of the capital in the family partnership."  

The existence of the family relationship "is simply a warning that things may not be what they seem" and "transactions between family members will be carefully scrutinized" to determine whether the donee partner acquired sufficient dominion and control over the transferred property to influence the conduct of the partnership in the disposition of its income and thus become a "true partner."  

B. The Law Since 1951.  

Either courts were confused with the Culbertson holding or they simply refused to apply it, for several cases decided immediately after Culbertson held in practical effect that an intra-family gift of a partnership interest, where the donee performs no vital or management services, would not usually be a sufficient basis for a valid family partnership.  

30. 327 U.S. at 286.  
31. The Court conceded that the absence of a contribution of either "vital services" or "original capital" places a heavy burden for showing the requisite intent. However, this burden may be discharged by showing that, notwithstanding the absence of these elements, other evidence exists from which the requisite intent and business purpose may be determined. See Herman Feldman v. Commissioner, 14 T.C. 17 (1950).  
32. 337 U.S. at 745.  
33. Id. at 746.  
34. As stated by the Senate Committee on Finance in its report accompanying the 1951 amendments [S. Rept. No. 781, 82 Cong., 1st Sess. 38 (1951)]: "the frequency with which the Tax Court, since the Culbertson decision, has held invalid family partnerships based upon donation of capital, would seem to indicate that, although the opinions often refer to 'intention,' 'business purpose,' 'reality,' and 'control,' they have in practical effect reached results which suggest that an intra-family gift of a partnership interest, where the donee performs no substantial services, will not usually be the basis of a valid family partnership for tax purposes." Not all courts were confused, however. At least one, in Visintainer v. Commissioner, 187 F.2d 519 (10th Cir. 1951), decided prior to the 1951 legislation, not only heeded the Culbertson mandate but also sensed the direction in which the wind was blowing. At 522 the court states that "membership in the immediate family alone and without more is no ground for disregarding for income tax purposes gifts of property made by a father to his children . . . the test to be applied in a case of this kind is whether good faith, bona fide gifts were made to the children. . . ." For a box-score of the post-Culbertson decisions, see Packel, The Next Inning of Family Partnerships, 100 U. Pa. L. Rev. 153, 155 (1951).
Congress realized that the *Culbertson* decision was not providing the tax treatment to partnership interests acquired by gift from a family member to which Congress felt they were entitled.\(^{35}\) Primarily to insure compliance with the basic tax principle that income attributable to property is taxable to the owner of the property, and, consequently, that a gift of a family partnership interest is to be respected for tax purposes where there is a real transfer of ownership,\(^{36}\) in 1951 Congress adopted amendments\(^{37}\) which were re-enacted without substantial change as section 704(e) of the 1954 Code.

Section 704(e) (1)\(^{38}\) provides that, for tax purposes, a person should be recognized as a partner in a family partnership in which capital is a substantial factor in the production of income, so long as he owns a capital interest in the partnership. Under this section, it is irrelevant how the partnership interest was acquired.\(^{39}\)

Thus, where section 704(e) applies, it effects a shift in emphasis away from the *Culbertson* inquiry into the existence of a "good faith intent" and "business purpose" to an inquiry into the reality of the donee's ownership of a capital interest.\(^{40}\)

The regulations under section 704(e) are particularly detailed in setting forth the factors the Commissioner (and probably the courts) will consider in determining the bona fides of a transfer of a partnership interest.\(^{41}\) More generally, the Senate Committee Report points out

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35. "Although there is no basis under existing statutes for any different treatment of partnership interest, some decisions in this field have ignored the principle that income from property is to be taxed to the owner of the property." Senate Committee on Finance Report, *supra* note 34, at 39.

36. "[T]o harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business [is the purpose of § 704(e)]. Two principles governing attribution of income have long been accepted as basic: (1) income from property is attributable to the owner of the property; (2) income from personal services is attributable to the person rendering the services. There is no reason for applying different principles to partnership income. If an individual makes a bona fide gift of real estate, or of corporate stock, the rent or dividend income is taxable to the donee. Your committee's report makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner." Senate Committee on Finance Report, *supra* note 34, at 38.


38. Section 704(e) (1): "A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person."

39. See note 36 *supra*.

40. Under § 704(e), the purchase by one family member from another of a capital interest in a partnership is treated as though the transfer were made by gift. Thus, whether a family member acquires his partnership interest by purchase or gift, he is referred to as a "donee." Int. Rev. Code of 1954, § 704(e) (3).


42. Treas. Reg. § 1.704-1(e) (2) (1956).
that in determining the bona fides of family partnerships, the same standards apply as in determining the bona fides of other intra-family transactions.\textsuperscript{43} It is apparent that the principles enunciated in \textit{Helvering v. Clifford},\textsuperscript{44} an analogous trust situation, are also relevant, especially where the family partnership involves the use of the trust device for minor children as partners.

Taken as a whole, the 1951 amendments, though not intended as a codification or restatement of existing law,\textsuperscript{45} restated basic tax principles as they relate to family partnership interests created by gift. The legislation was, in effect, a congressional mandate to the Commissioner and the courts to apply the basic tax principle that income earned by property is taxable to the owner of the property, as long as the ownership is real. The amendments also served notice that the established administrative rule—that transactions between family members which have the effect of reducing taxes will be subjected to close scrutiny—should not take precedence over the afore-mentioned tax principle concerning taxation of income attributable to property.

\section*{III. Present Considerations in Establishing a Family Partnership}

\subsection*{A. Governing Principles.}

The inquiry into the present requirements for establishing a valid family partnership proceeds on two levels: (1) what principles govern the recognition of family partnerships for income tax purposes, and (2) what facts and circumstances are relevant evidentiary matters in connection with the governing principles.\textsuperscript{46}

As previously pointed out, Congress, in 1951, established new principles governing income tax recognition of family partnerships. The statutory provisions, reenacted as section 704(e) of the 1954 Code, provide that, for taxable years beginning after December 31, 1950, a person

\begin{footnotesize}
\textsuperscript{43} Senate Committee on Finance Report, \textit{supra} note 34, at 39.
\textsuperscript{44} 309 U.S. 351 (1940). The \textit{Clifford} principles are essentially to the effect that where a person who has purportedly transferred property to another in practical effect retains substantial dominion and control over the property, either under the terms of the arrangement or by the circumstances upon its creation and operation, the transferor remains taxable on the income attributable to the property.
\textsuperscript{45} Jack Smith, 32 T.C. 1261 (1959).
\textsuperscript{46} Aside from the principles peculiarly applicable to family partnerships, other tax principles must be complied with. The principle that income is taxable to the person whose personal service or property earned it requires that any person seeking partner status must establish a contribution of either capital or services to the partnership during the taxable period in question. Commissioner \textit{v. Culbertson}, 337 U.S. 733, 739 (1949). The taxpayer must also prove the existence of a partnership agreement, either expressed in words or implied from conduct. 40 AM. JUR. \textit{PARTNERSHIPS} § 18 (1942).
\end{footnotesize}
shall be recognized as a partner if he owns a capital interest in a partnership in which capital is a material income-producing factor. Section 704(e) initially raises the question of what types of partners and partnerships are entitled to the blanket recognition afforded by its provisions.

In so far as partners are concerned, section 704(e) applies only to those who possess a "capital interest." A "capital interest" in a partnership consists of an interest in the assets of the partnership which is distributable to the partner upon his withdrawal from the partnership or upon liquidation of the partnership. A mere right to participate in the earnings of a partnership does not constitute a "capital interest" within the statutory meaning of the term.

To prevent the deflection of personal service income to other family members through the device of donated capital interests, section 704(e) (1) logically requires that capital be a substantial income-producing factor in the partnership's business if a donee's status as a partner is based solely upon ownership of partnership capital. Thus answering the previous inquiry of what type of partnerships are covered by section 704(e), it is only those in which "capital is a material income-producing factor." There is no single test to determine whether "capital is a material income-producing factor" in a partnership. The determination is a factual in-

47. Generally the blanket recognition of family partnerships accorded under § 704(e) is favorable to the taxpayer, but it can be a two-way street for the taxpayer who chooses to read the future in only one way and focuses only on tax minimization. In some cases family partnerships have suffered losses and taxpayers, hoping to secure the entire loss deduction, have reversed themselves claiming that the partnerships were not real. Usually, however, courts have held the taxpayer of his election to do business as a partnership. See Maletis v. United States, 200 F.2d 97 (9th Cir. 1952) (a taxpayer who established a partnership which was valid under state law, conducted business representing the business as a partnership to the Government, filed partnership tax returns, and obtained a tax benefit, cannot repudiate the partnership in order to obtain a tax benefit for himself even though the partnership may, in fact, be unreal for income tax purposes). While the taxpayer may be bound by his election to do business as a partnership, the Government is not so bound.

48. The provisions of § 704(e) are ostensibly applicable to family partnerships and one might infer that only family members are covered. This is not the case and non-family members may be recognized as partners under the statutory provisions. For instance, § 704(e) (1) states that "a person shall be recognized as a partner... if he owns a capital interest in a partnership in which capital is a material income-producing factor..." This does not limit the recognition to family members. The court in Pogetto v. United States, 193 F. Supp. 688, 689-90 (N.D. Cal. 1961) discussed this aspect: "The so-called family partnership problem appears in partnerships not composed exclusively of family members, and in this sense the term 'family partnership' may be a misnomer. For example, ... it is ... clear that several members of the partnership (considered herein) are not related to the Pogetto family. However, the so-called family partnership provisions of the Internal Revenue Code are applicable."

FAMILY PARTNERSHIPS

Relevant considerations in this connection include: the total amount of partnership capital, the nature of the enterprise, the use made of the capital, the type of assets held by the partnership, the portion of the partnership income attributable to personal services as compared with the portion attributable to capital, the need of the enterprise for capital, and consequently, the benefit to the enterprise from invested capital, and other similar considerations.

Normally capital is considered a material income-producing factor if the operation of the enterprise requires the maintenance of a substantial inventory or a substantial investment in plant, machinery, or equipment. On the other hand, capital is not ordinarily a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services.

Since the 1948 joint-return amendment removed the tax incentive for a husband to establish his wife as a partner, the family partnership battles of the future will probably involve minor children or trustees for minor children who will base their claim for status as a partner on donated capital interests. Consequently, the statutory principles will probably govern most future family partnership transactions. However, in those situations where section 704(e) is inapplicable—either because the challenged partner does not own a "capital interest," there is no invested capital or invested capital is a negligible income-producing factor, or the taxable year involved is prior to January 1, 1951—the Culbertson "intent" criteria remains vital and the taxpayer must prove that the chal-

53. Pogetto v. United States, 306 F.2d 76 (9th Cir. 1962) (partner not recognized because her capital investment did not benefit the income-producing capacity of the partnership business). In Greenburger v. Commissioner, 177 F.2d 990, 994 (7th Cir. 1949) the court stated that "the capital invested in the partnership was not large, but the point is that [the partners] decided it was sufficient for the needs of the business. . . ." See, Packel, The Next Inning of Family Partnerships, 100 U. Pa. L. Rev. 153, 159 (1951). Cf. Charles M. Peisner, 26 P-H Tax Ct. Memo 405 (1957) where the court said it was enough to make capital an important income-producing factor that capital was required for the business to begin operation.
55. Ibid.
56. INT. Rev. CODE OF 1954, § 6013.
57. The statutory standard is only applicable to tax years beginning after December 31, 1950. The 1951 amendment states that "the determination as to whether a person shall be recognized as a partner for income tax purposes for any taxable year beginning before January 1, 1951, shall be made as if this section had not been enacted and without inferences drawn from the fact that this section is not expressly made applicable with respect to taxable years beginning before January 1, 1951." § 340(c) of the Revenue Act of 1951.
58. Under the Culbertson test attention is focused upon the subjective question of the bona fide intention of the parties to join together in the present conduct of the business as a partnership. The requisite intent is to be gleaned from "the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of
lenged partner contributed to the production of partnership income in some way other than by investment of capital, such as by rendering vital services.\(^{59}\)

B. Relevant Evidentiary Matters.

Under the statutory standard of section 704(e), inquiry is directed to the fact of "actual ownership" by the challenged partner of a capital interest in the partnership.\(^{60}\) The heart of the issue is whether there has been an absolute transfer of a capital interest and whether the donee thereafter has dominion and control over the interest, or, conversely, whether the donee's partnership interest represents a mere surface change of ownership. The Commissioner has adopted regulations setting forth factors for consideration in determining the reality for income tax purposes of a donee's ownership of a partnership interest.\(^{61}\)

Since the statutory standard became effective in 1951, there has been relatively little litigation under its provisions. However, the cases that have been decided and the regulations that have been adopted indicate that, in determining whether a donee has acquired actual ownership, the significant factors to consider include: (1) controls, both direct and indirect, which the donor has retained over the purportedly transferred capital interest, (2) management participation by the donee, (3) actual distribution to the donee of his share of partnership income, (4) conduct of the partnership business, (5) documentary evidence, (6) motive and business purpose for transferring a capital interest to the donee, and (7) state law.

Two things should be kept in mind while reading the following discussion of these significant evidentiary factors. First, no one of the fac-

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\(^{59}\) The relation between § 704(e) and the Culbertson test is illustrated in Pogetto v. United States, 306 F.2d 76, 79 (9th Cir. 1962) where the court stated that the challenged partner "cannot be ignored as a partner . . . simply because [the taxpayers] have failed to satisfy the objective standards of § 704(e)(1). In order to disregard [her] as a partner for income tax purposes, it must also appear that the parties did not in good faith intend to join together as partners."

\(^{60}\) "Actual ownership," i.e., the type of ownership required by § 704(e), means more than mere legal ownership. It means legal ownership plus dominion and control over the property purportedly owned.

Factors standing alone will normally be conclusive. The existence of the requisite ownership cannot be determined by isolated circumstances tending one way or another, or by any formal or specific test. It must be ascertained by weighing all the facts and circumstances of each particular case. A second thing to keep in mind is that the following discussion of significant factors applies to family partnership situations in general, regardless of whether the partnership involves general or limited partners, trusts and trustees, minor partners, or any other special situation.

1. Controls Retained by the Donor Over the Transferred Interest. Any partnership arrangement, even at arm’s length, must necessarily involve some restrictions which curtail each partner’s dominion and control over his partnership interest. Thus, not every restriction on the donee’s control of his partnership interest will be indicative of a lack of true ownership in the donee. The issue where family partnerships are concerned is whether the donor retains, directly or indirectly, so many of the incidents customarily identified with ownership as to constitute a restriction of ownership inconsistent with the normal relationships among partners. The regulations list the following donor-retained controls as particularly significant indicia of a lack of real ownership in the donee: determination of the distribution of partnership income, restrictions on donee’s withdrawal from the partnership, control of the donor of assets essential to the business, and retention by the donor of management powers inconsistent with the normal relationship between partners.

One of the customary incidents of ownership of a partnership interest is the right to have some voice in the determination of when and in what amounts partnership earnings will be distributed. Where such determination rests solely within the donor’s discretion, it tends to refute the reality of the donee’s ownership. It is not uncommon in ordinary business relationships for partners to consent to accumulate earnings to the extent that they are reasonably required for the anticipated needs of the business and such an accumulation of earnings would ordinarily be

63. Senate Finance Committee Report, Sen. Rep. No. 781, 82d Cong., 1st Sess. 38 (1951): “Not every restriction upon complete and unfettered control by donee of the property donated will be indicative of sham in the transaction. Contractual restrictions may be of the character incident to the normal relationships among partners. Substantial powers may be retained by the transferor as a managing partner or in any other fiduciary capacity which, when considered in the light of all the circumstances, will not indicate any lack of true ownership in transferee. In weighing the effect of a retention of any power upon the bona fides of a purported gift or sale, a power exercised for the benefit of others must be distinguished from a power vested in transferor for his own benefit.”
64. Treas. Reg. § 1.704-1(e) (2) (ii) (d) (1956).
considered a neutral factor.

However, if the donor retains the right to accumulate earnings beyond the reasonably anticipated needs of the business, this would constitute a serious infringement upon the donee’s enjoyment of the benefits of ownership and weigh against a finding of real ownership in the donee.

Another customary incident of ownership of a partnership interest is the freedom to withdraw the interest from the partnership and sell or otherwise dispose of the interest without financial detriment. In this light, a partnership agreement which places withdrawal or disposition of the donee’s interest solely within the donor’s discretion is indicative of a lack of real ownership in the donee.

Nor can it be said that a donee is free to withdraw or dispose of his interest when he may do so only at a financial loss as, for example, where the partnership agreement permits one or more of the other partners to purchase the donee’s interest for substantially less than its fair market value.

Also, a “... donee shall not be considered free to liquidate his interest unless, considering all the facts, it is evident that the donee is independent of the donor and has such maturity and understanding of his rights as to be capable of deciding to exercise, and capable of exercising, his right to withdraw his capital interest from the partnership.”

It would seem however that some reasonable restrictions on withdrawal do not indicate a lack of real ownership in the donee, such as a requirement to give a reasonable notice to other partners prior to withdrawal.

The regulations also recognize that if the donor retains control of assets which are essential to the partnership business, he may manipulate these in such a manner as to render the donee’s ownership of a partnership interest a mere sham. Such control of essential assets might, for instance, take the form of a family gift-leaseback transaction with an extremely restrictive lease.

It is not uncommon in normal partnership arrangements for one partner to be made managing partner or to be given majority voting control. Hence, retention by the donor of management power or voting

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68. See Ray R. Offord, Jr., 30 P-H Tax Ct. Memo 871 (1961) (withdrawal of interest possible only at a price likely to be less than fair market value).
70. Treas. Reg. § 1.704-1(e) (2) (ii) (c) (1956).
71. Cf., White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951).
control, standing alone, is normally a neutral factor.\textsuperscript{72} This would seem to be particularly true where the retained controls are hedged with safeguards to protect the donee, such as where the donor is operating under a revocable power of appointment to manage or where the donee has the right to continually investigate the management operation and be furnished with periodic management reports.\textsuperscript{75} On the other hand, retention by the donor of such management powers as are not common in normal business arrangements may militate against a finding of real ownership in the donee. Such uncommon management powers are exemplified by the previously discussed retention by the donor of complete discretion over the donee's withdrawal from the partnership or over distribution of partnership earnings. In addition, complete power in the donor to determine liquidation or dissolution of the partnership is not common in a normal partnership arrangement.\textsuperscript{74} The danger of retaining uncommon management powers is particularly acute where the retained powers are coupled with restrictions upon the donee's right to withdraw his interest from the partnership.\textsuperscript{75}

2. \textit{Management Participation by Donee.} While substantial management participation by the donee is not essential under section 704(e), it is strong evidence that the donee exercises dominion and control and is a real owner of a capital interest.\textsuperscript{76} Such participation does not necessarily have to involve continuous management activity, but it does require the exercise of some independent judgment on major business decisions.\textsuperscript{77} An occasional refusal to go along with the donor-partner would be quite indicative of management participation by the donee.\textsuperscript{78} Such participation by the donee, to be of probative value, presupposes some acquaintance with and interest in the operations of the particular partnership business, as well as sufficient experience and maturity as indicates a competence to grasp business problems.\textsuperscript{79}

3. \textit{Distribution of Income to the Donee.} Actual distribution to a

\textsuperscript{72} Treas. Reg. § 1.704-1(e)(2)(ii)(d) (1956). See Jack Smith, 32 T.C. 1261 (1959) (mere fact that trusts had minority voting position does not establish that donors retained control over the interest); Charles M. Peisner, 26 P-H Tax Ct. Memo 405 (1957) (donor reserved right to be in active charge of management). In Theodore D. Stern, 15 T.C. 521 (1950) the court stated that "of themselves . . . these . . . provisions giving [the donor] extensive [management] authority are not conclusive, for partnership affairs frequently are conducted by a managing partner who has such authority."

\textsuperscript{73} Charles M. Peisner, 26 P-H Tax Ct. Memo 405 (1957).

\textsuperscript{74} See Henry S. Reddig, 30 T.C. 1382 (1958).

\textsuperscript{75} Treas. Reg. § 1.704-1(e)(2)(ii)(d) (1956); see Henry Reddig, 30 T.C. 1382 (1958).

\textsuperscript{76} Treas. Reg. § 1.704-1(e)(2)(iv) (1956).


\textsuperscript{79} Treas. Reg. § 1.704-1(e)(2)(iv) (1956).
donee of all or a substantial portion of his share of partnership income is a factor of substantial weight tending to evidence the reality of the donee's ownership of an interest,\(^{80}\) provided that the donee actually enjoys the benefits of the distribution.\(^{81}\) On the other hand, if the distributions are subject to the donor's control or are used for the donor's benefit, this would indicate a lack of real ownership in the donee.\(^{82}\)

4. Conduct of the Partnership Business. Meticulous conduct of the partnership business in a manner wholly consistent with, and in no material respect different than, customary practices followed in normal partnerships composed of unrelated persons is a persuasive factor indicative of the reality of the donee's interest, provided there are not also present other more persuasive circumstances indicating that the donor has retained substantial ownership of the interest purportedly transferred.\(^{83}\) In this connection, a factor of primary significance is publicly holding out the donee as a partner in normal business operations.\(^{84}\) Other factors of significance favorable to a finding of real ownership in the donee include: conduct of the business in strict conformity with the letter and spirit of trust instruments and partnership agreements;\(^{85}\) establishment of separate capital and drawing accounts in the donee's name on the partnership books;\(^{86}\) recognition of the donee in the filing of fiduciary and partnership tax returns;\(^{87}\) compliance with local partnership, ficti-

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\(^{81}\) Cf. Commissioner v. Culbertson, 337 U.S. 733, 747 (1949) ("whether [a donee] is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise.").

\(^{82}\) Treas. Reg. § 1.704-1(e)(2) (v) (1956).


\(^{84}\) Treas. Reg. § 1.704-1(e)(2)(vi) (1956); see, e.g., Jack Smith, 32 T.C. 1261 (1959) (partnership's bank, customers, creditors, and Dunn and Bradstreet were made aware that partnership included trustee-partner).


\(^{86}\) See Jelindo A. Tiberti, 31 P-H Tax Ct. Memo 1058 (1962); James N. Bennett, 31 P-H Tax Ct. Memo 991 (1962). However, mere establishment of distinct accounts on partnership books is of little value if they are not respected in practice. In Henry S. Reddig, 30 T.C. 1382 (1958), where the donee was not recognized for income tax purposes, the court considered withdrawals by the donors in excess of the balance of their capital accounts on the partnership's books as being a crucial factor.

\(^{87}\) Treas. Reg. §§ 1.704-1(e)(2)(vi)(e) and (f) (1956); see Jelindo A. Tiberti, 31 P-H Tax Ct. Memo 1058 (1962); Jack Smith, 32 T.C. 1261 (1959); cf. Ray R. Oford, Jr., 30 P-H Tax Ct. Memo 871 (1961) (no partnership returns were filed thus creating the presumption that no partnership in fact existed); see also, Cooper v. United States, 6 Am. Fed. Tax R.2d 5728 (E.D. Wash. 1960) (both state and federal gift tax returns reported the fact of the gift).
tious names, and business registration statutes; recognition of the
donee's interest in insurance policies, leases, and other business contracts,
and in litigation affecting the business.\textsuperscript{89}

5. \textit{Documentary Evidence.} Legally sufficient deeds, instruments
of gift, partnership agreements, trust instruments, and other types of
documentary evidence are relevant factors, but, standing alone, they cannot
establish the reality of ownership of an interest.\textsuperscript{90} In connection with
both documentation and other formalistic factors previously adverted to,
it is basic to the application of the income tax laws that the Government
is not bound by appearances, but rather may inquire into the substance of
a situation.\textsuperscript{91} Thus, while such factors are relevant and their absence
harmful, it would be folly to rest a case for recognition exclusively on
such evidence.

6. \textit{Motive.} Under the statutory standard of section 704(e), the
motivation for making a donee a partner is accorded little weight as an
independently significant factor.\textsuperscript{92} If other factors establish the reality
of a donee's ownership, motive alone will not be a ground for not recog-
nizing the donee as a partner. However, motive remains one of the con-
siderations since it tends to color other significant factors. For instance,
while a tax-saving motive is not incompatible with the intention to create
a bona fide partnership, the presence of such a motive may be a tip-off
that things are not what they appear to be—that a taxpayer in an over-
zealous effort to save taxes has created an arrangement with all the ex-
ternal trappings of partnership, but without the accompanying intention
of carrying on the business as a bona fide partnership. On the other
hand, where there is an absence of a tax-saving motive or where there is
a business purpose for making a donee a partner, e.g., where the donee's
skills are helpful in furtherance of the partnership business,\textsuperscript{93} there would

\textsuperscript{88} Treas. Reg. § 1.704-1(e) (2) (vi) (a) (1956).
\textsuperscript{89} Treas. Reg. § 1.704-1(e) (2) (vi) (d) (1956).
\textsuperscript{90} Jack Smith, 32 T.C. 1261 (1959) (donee's ownership is not established by le-
gally sufficient instruments of partnership and gift); George L. Meffley, Sr., 26 P-H
Tax Ct. Memo 675 (1957); Pfugradt v. United States, 201 F. Supp. 379, 384 (E.D.
Wis. 1962) ("the bona fides of the purported ownership is not shown simply by the fact
that legally sufficient documents of transfer have been created. . . ."); cf. Eckhard v.
Commissioner, 182 F.2d 547, 550 (10th Cir. 1950) (absence of a formally executed part-
nership agreement is not fatal).
\textsuperscript{91} In Higgins v. Smith, 308 U.S. 473, 477 (1940) the Supreme Court stated: "The
Government may look at actualities and upon determination that the form employed for
doing business or carrying out the challenged tax event is un-real or a sham may sustain
or disregard the effect of the fiction as best serves the purposes of the tax statute."
\textsuperscript{92} Treas. Reg. § 1.704-1(e) (2) (x) (1956). If the ownership of the donee is
real, it is immaterial what motivated the transfer or whether the partnership business
profited from the addition of the partner.
\textsuperscript{93} See G.A. Paul, 26 P-H Tax Ct. Memo 640 (1957); Finlen v. Healy, 187 F.
be less reason to question what otherwise appears to be a bona fide partnership arrangement.

7. **State Law.** To a considerable extent, state law determines the legal relationships of partners among themselves and with the public. Thus, evidence that a transfer of property is complete and binding under state law, conduct of the business in accordance with state law, and other evidence of compliance with state law are factors to be considered in determining the reality of ownership of an interest in a family partnership. However, recognition or non-recognition of family partnerships under state law is in no way controlling for federal income tax purposes. Nor will legal disabilities under state law which prevent a person from becoming a partner prevent his recognition as a partner in a family partnership for federal income tax purposes. The non-binding effect of state law results from the fact that the standards for determining the federal income tax status of individuals and organization as partners and partnerships are established by the Internal Revenue Code. This discussion of relevant evidentiary matters such as retained controls, income distribution, participation in management, etc., is not intended to state comprehensively all the relevant factors applicable in the determination of the reality of ownership, but rather is designed to emphasize the importance of these factors as evidence of the reality of the donee's ownership. In establishing family partnerships in the future under the statutory standard of section 704(e), one should, for the most part, use the regulations promulgated and the cases decided under section 704(e) as a starting point. However, one cannot completely disregard all that happened before 1951. In practice many of the considerations used for determining the intent to form a partnership under the Culbertson "intent" test apply equally in determining reality of ownership under the statutory standard. Also, one of the central issues under section 704(e) is whether a gift will be effective for income tax purposes. Thus, the cases applying the Clifford principles are still important in the family partnership area since these principles bear on the completeness of a gift.

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97. Section 6031 of the Code requires that, with certain exceptions, any unincorporated organization, defined as a "partnership" for federal income tax purposes according to § 761, must file a Form 1065 information return. The determination under § 761 of what constitutes a partnership is made without regard to state law. Thus an organization not a partnership under state law could still file a Form 1065.
transfers of property.98

C. Minor Children and Trustees as Partners.

Recognition of minor children as the real owners of partnership interests acquired through intra-family transfers is determined under the same principles as are generally applied in determining whether any family member is entitled to recognition as a partner for income tax purposes. Determination of the reality of a minor's ownership of a partnership interest resolves into an inquiry whether the particular child possesses sufficient maturity and experience to indicate his competence to manage his own property and participate in partnership activities in accordance with his interest in partnership property.99 When a minor child possesses the requisite maturity and experience to such an extent that disinterested persons treat him as competent to enter into business dealings and otherwise conduct his affairs on an equal footing with adults, it is likely that he will be recognized as a partner in the family partnership.100 Ordinarily, however, in the absence of a clear showing of actual competence, it is an extremely dangerous practice to make a minor child a partner directly in the partnership without appointing an independent fiduciary to manage the interest for the child's sole benefit.101 This warning stems from the fact that normally a minor child will lack the competence to exercise the requisite dominion and control over his interest as to result in recognition of him as a partner.

In addition to a minor child's customary immaturity and inexperience,
ence, the question of participation directly in the partnership may be further complicated by the minor child's legal disabilities under state law. The Commissioner, however, will not press these legal disabilities so far as to deny the competence of minors to control their property where the circumstances indicate the existence of such competence in fact.\textsuperscript{102}

Since a minor child will ordinarily not be recognized as a partner in his own behalf, it is usually necessary that his interest either be managed by a judicially-supervised adult acting in a fiduciary capacity or be held in trust and managed by a trustee.\textsuperscript{103} Where the minor's interest is managed by a fiduciary other than a trustee, such person represents the child in relation to the partnership and the child is considered to be the actual partner. In such a situation, the minor child will be recognized as the real owner of the interest only where the fiduciary manages the property for the minor's sole benefit and where there is present such judicial supervision of the fiduciary's conduct as is required by law.\textsuperscript{104}

The more common solution of the problems involved in transferring partnership interests to minor children is to hold the minor's interest in trust, establishing the trustee as the legal owner of the interest. In this situation the trustee, rather than the minor, is considered to be the partner. Where the interest is held in trust, the critical inquiry is again the recurring one under the statutory standard of whether the trustee, in his fiduciary capacity, is the real owner of the interest or whether the donor has retained such dominion and control over the interest or control over the trustee as to remain the substantial owner of the interest purportedly transferred.\textsuperscript{105} The reality of a trustee's ownership will be tested under the same principles as are generally applied in determining whether any family member is entitled to recognition as a partner for income tax

\textsuperscript{103} Use of either of these devices is sanctioned by the regulations. See Treas. Reg. §§ 1.704-1(e)(2)(vii) and (viii) (1956).
\textsuperscript{104} Treas. Reg. § 1.704-1(e)(2)(viii) (1956). While guardianship is expressly approved by the regulations, it is a cumbersome procedure and may not be too practical. For a discussion of the considerations involved in using the guardianship device, see Bennion, \textit{How to Split Income Through Family Partnerships}, P-H Tax Ideas Rep. §§ 13003, 13003.4(1).
\textsuperscript{105} Treas. Reg. § 1.704-1(e)(2)(vii) (1956); see Henry S. Reddig, 30 T.C. 1382 (1958); Jack Smith, 32 T.C. 1261 (1959); Roy C. Acuff, 33 T.C. 126 (1960); Harry L. Bialock, 35 T.C. 649 (1961); Commissioner v. Brodhead, 18 T.C. 726 (1952). The trustee was recognized as a partner in the following decisions which are not covered by § 704(e): West v. Commissioner, 214 F.2d 300 (5th Cir. 1954); Miller v. Commissioner, 203 F.2d 350 (6th Cir. 1953); Pike v. Commissioner, 231 F.2d 688 (9th Cir. 1956).

The decisions under § 704(e) indicate that some courts regard the statutory standard as essentially declaratory of the requirements under the \textit{Culbertson} decision. See Spiessman v. Commissioner, 260 F.2d 940 (9th Cir. 1958); Henry S. Reddig, 30 T.C. 1382 (1958). Other courts, however, have considered the advent of the statutory rules as warranting a re-examination of partnerships in which trusts had previously been rejected. See Jack Smith, 32 T.C. 1261 (1959).
purposes. Additionally, there are certain factors to consider which are peculiar to the trust situation. For instance, selection of a proper trustee will often weigh heavily in favor of the trustee being recognized as a partner. The safest course in selection of a trustee is the appointment of someone who is unrelated to and completely independent of the donor. The regulations provide that a trustee will ordinarily be recognized as a partner if he is “unrelated to and independent of the grantor . . . participates as a partner and receives distribution of the income distributable to the trust. . . .”

While the safest course is to choose an independent trustee, cases may arise where, as a practical matter, the grantor may desire or be limited to choosing himself, his wife, his attorney, or some close business associate or friend as trustee. Recognition of the trustee as a partner has been accorded in such cases, provided the trustee has fulfilled his fiduciary duties. There is, however, a great temptation in such cases for the trustee to make decisions and to exercise his powers over the trust with a primary interest in benefiting the grantor and not the trust beneficiary. This great temptation to exercise fiduciary powers for the grantor’s benefit makes appointment of the grantor himself or someone amenable to his will a dangerous practice inviting close scrutiny of the transaction to determine whether the trustee is the real owner of the interest in a fiduciary capacity. Three general aspects which are closely scrutinized are: (1) provisions of the partnership agreement; (2) provisions of the trust instrument; and (3) conduct of the parties to ascertain whether the trustee has scrupulously adhered to the provisions of the trust instrument. In addition, two other specific factors which will be given particular consideration are whether the trustee is held out as a partner in dealings with customers and creditors and whether the trust’s share of partnership income, beyond that retained for the reasonably anticipated needs of business, is distributed to the trust annually and

110. Treas. Reg. § 1.704-1(e) (2) (vii) (1956); see Henry S. Reddig, 30 T.C. 1382 (1958) (business associate of donor not recognized as partner).
paid to or reinvested for the trust beneficiary.\textsuperscript{112}

Although particularly true where no independent trustee is appointed, the provisions of the trust instrument will always be examined to determine that the normal fiduciary obligations are imposed upon the trustee and that no important controls over the partnership interest are retained by the grantor.\textsuperscript{113} Among the trust provisions which may be considered as weighing in favor of recognition of a trustee as a partner are the following: a provision specifically making the instrument irrevocable;\textsuperscript{114} provisions authorizing the trustee to invest any or all of the trust corpus as he sees fit,\textsuperscript{115} including the power to completely refuse to invest in the partnership and the power to withdraw a previous investment;\textsuperscript{116} and any other provisions which generally accord to the trustee complete discretion in the administration of the trust.\textsuperscript{117} On the other hand, existence of any of the following provisions may indicate that the trustee's ownership may be less than real: provisions which require or merely permit any trust corpus or income or benefits thereto to revert directly or indirectly to the donor;\textsuperscript{118} provisions generally reserving to the donor powers of administration of the trust;\textsuperscript{119} provisions generally requiring that the trust corpus be invested in any particular manner, and more especially requiring it to be invested in the partnership;\textsuperscript{120} provisions directing the trustee to act always in the best interests of the partnership, even at the expense of his fiduciary obligations;\textsuperscript{121} and generally any provision designed to curtail full enjoyment of ownership by the donee. Although the presence of any one of these undesirable provisions

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  \item \textsuperscript{112} Treas. Reg. §§ 1.704-1(e) (2)(vii)(a) and (b) (1956).
  \item \textsuperscript{113} For suggestions in creating the trust and in drafting the trust instrument, see Jessup, \textit{How to Draft the Partnership Agreement and Trust Provisions for a Family Partnership With Trusts as Partners}, 1956 So. Cal. Tax Inst. 137; Bennion, \textit{How to Split Income Through Family Partnerships}, P-H Tax Ideas Rep. ¶¶ 13003, 13003.4(4).
  \item \textsuperscript{115} Dickstein v. McDonald, 149 F. Supp. 580 (M.D. Pa. 1957).
  \item \textsuperscript{116} Dickstein v. McDonald, 149 F. Supp. 580 (M.D. Pa. 1957). However, the court in Swinerton v. Smyth, 7 Am. Fed. Tax R.2d 923 (N.D. Cal. 1961) states that continued investment of trust corpus in the partnership business is not an indication of retained control since the business continued to be profitable.
  \item \textsuperscript{117} A provision giving a trustee power to completely refuse to invest in the partnership is usually only practical where a grantor transfers non-partnership property. In the case where a grantor transfers a partnership interest it is meaningless to provide that the trustee can refuse to invest it in the partnership since it is already invested therein.
  \item \textsuperscript{121} Henry S. Reddig, 30 T.C. 1382 (1958).
  \item \textit{Ibid.}
\end{itemize}
is not necessarily fatal to recognition, they should be avoided so far as is possible. It should be remembered, however, that even though a trust instrument contains only the most proper provisions, it will be given little weight if the provisions are disregarded in the actual conduct of the partnership business.

Aside from the provisions of the trust instrument and the factors associated with selection of a trustee, other factors have been considered particularly significant in trust situations. Actual distribution of all or a substantial portion of the trust’s share of partnership income by the trustee to the trust beneficiary is persuasive evidence of the bona fides of a trustee’s interest. Formalistic and other documentary evidence, such as the filing of fiduciary returns reflecting the trust’s share of income, though less persuasive than distribution of income, may be considered as indicative of real ownership in the trustee. Obviously, any evidence tending to show that the grantor does not control the use or investment of trust corpus or income is also a strong indication that the trustee is the real owner of the interest purportedly transferred. Actual investment of part of the trust corpus outside of the partnership would be such evidence. However, distributions of trust income or corpus which are applied to the grantor’s benefit, such as payment of family expenses for which the grantor is legally responsible, tend to show retention by the grantor of substantial ownership of the interest allegedly transferred.

Completely apart from family partnership considerations, the creation of a trust for the benefit of a member of the grantor’s immediate family raises the possibility that the trust’s income will be taxed to the grantor under the Clifford principles. Thus, it is also necessary when contemplating use of a trust to adhere closely to the so-called “Clifford

122. Treas. Reg. § 1.704-1(e)(2)(vii) (1956); Swinerton v. Smyth, 7 Am. Fed. Tax R.2d 923 (N.D. Cal. 1961). While actual distribution of trust corpus or income to a beneficiary is strong evidence that the grantor has relinquished ownership of the trust property, absence of distributions to the beneficiary does not lead to the opposite inference. Since children are commonly too immature to handle funds for their own use, it is a customary fiduciary power for a trustee to accumulate income for the beneficiary. This power could be exercised either in accordance with provisions of the trust instrument or in carrying out general fiduciary obligations.


124. See note 115, supra.


126. See note 44 supra.
regulations" in establishing the trust.\textsuperscript{127}

D. \textit{Family Partnerships with Limited Partners.}

A donee of a limited partnership interest may also be recognized for income tax purposes as a partner in a family partnership.\textsuperscript{128} Two characteristics of the normal limited partnership make it a potentially useful device, especially where minor children or trustees are made partners: (1) limited partners have limited liability, and (2) limited partners normally do not participate in management.\textsuperscript{129} In the case where a donor desires to establish a minor child as a partner directly in a family partnership, the donor will ordinarily be confronted with the minor’s lack of maturity and experience to participate in management of the business. However, by establishing the minor as a limited partner, no significance would attach to the absence of management participation, such absence being a normal characteristic of limited partnership arrangements. In the case where a partnership interest is transferred in trust, the donor may be reluctant to give significant management powers to an independent trustee, and the trustee may be reluctant to become a general partner with unlimited liability. By making the trustee a limited partner, the donor may retain management control of the business and the trustee may enjoy limited liability.

Recognition of the donee of a limited partnership interest as a limited partner is determined by the same principles that govern recognition of a general partner; whether dominion and control were acquired over the partnership interest.\textsuperscript{130} Since the principles governing recognition of a

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  \item \textsuperscript{127} Cf. Apicella v. Commissioner, 28 T.C. 979 (1957) (trust denied recognition under the Clifford doctrine). The Clifford rules, §§ 671-78 of the Internal Revenue Code of 1954, generally state that a trust shall be disregarded for income tax purposes and the income taxed to the grantor if he retains substantial control over the trust corpus or income, or if the trust corpus or income will return to him in a relatively short time. While it appears possible that a trust recognizable under § 704(e) might be disregarded under the Clifford regulations, the reverse may also be possible. In unpublished rulings the Commissioner has indicated that the donor of a family partnership interest, which constitutes the corpus of a Clifford trust, will remain taxable on the trust income under the family partnership rules even though he is not taxable under the Clifford regulations. For a criticism of these rulings, see Herzfeld, `Grantor of Family Partnership Interest to Clifford Trust is Taxable, I.R.S. Says, 15 J. Taxation 50 (1961).
  \item \textsuperscript{128} Treas. Reg. § 1.704(e)(ix) (1956); see Theodore D. Stern, 15 T.C. 521 (1950); Stanback v. Commissioner, 271 F.2d 514 (4th Cir. 1959).
  \item \textsuperscript{129} 68 C.J.S. Partnerships § 471 (1951); “it is fundamental to a limited partnership that the limited partner have no part in the control or management of the business.”
  \item \textsuperscript{130} Treas. Reg. § 1.704-1(e)(2)(ix) (1956). Additionally, a limited partnership is required to be organized and conducted in strict compliance with applicable state law. See, e.g., Pflugradt v. United States, 201 F. Supp. 379, 382 (E.D. Wis. 1962). In a large number of states, the applicable limited partnership law is the Uniform Limited Partnership Act.
\end{itemize}
\end{footnotesize}
limited partner are generally the same as those governing recognition of
general partners, it is not surprising that the factors to be considered are
also the same. There are, however, important exceptions. On the one
hand, the Commissioner realizes that no significance can be attributed to
the absence of management participation owing to the nature of the
limited partnership. On the other hand, it is recognized that since the
limited partnership device readily lends itself to retention of substantial
controls in the donor, the donor is presented with a tempting opportunity
to render the donee’s ownership of an interest more apparent than real.
Accordingly, to insure against abuses in the use of the limited partner-
ship device, the regulations specifically caution that restrictions on the
donee’s right to liquidate or transfer his interest, provisions requiring
that the interest remain in the partnership for a long period, and reten-
tion generally by the donor of controls over the donee’s interest beyond
those which normally obtain in the light of applicable state law will evi-
dence a lack of real ownership in the donee.

E. Reallocation of Partnership Income.

Once a family partnership is recognized for income tax purposes, the
question arises whether the allocation of partnership income provided
by the partnership agreement will be given effect. Prior to 1951, the
general rule was that only the validity or nonvalidity of a family partner-
ship was open to question. Once a family partnership was held valid,
the income-allocation provisions were binding upon the Commissioner.

The Revenue Act of 1951 abandoned this “all-or-nothing” approach

131. Treas. Reg. § 1.704-1(e) (2) (ix) (1956): “participation in management by a
donee in a limited partnership is immaterial if the limited partnership meets all the
other requirements prescribed by this paragraph.”
132. Treas. Reg. § 1.704-1(e) (2) (ix) (1956). Where the Uniform Limited Part-
nership Act is the applicable law, there is no problem with restriction on assignment as
§ 19 of the act specifically makes the limited partner’s interest assignable.
133. If one or more challenged partners are not recognized for income tax purposes
because the donor remains the substantial owner of the property purportedly transferred,
the tax liability on the income allocable to the purportedly transferred interest will fall
on the donor since he is treated as the owner of the property for income tax purposes.
Non-recognition of challenged partners, in this context, would increase only the donor’s
distributive share of partnership income; the distributive share of any donee who is
recognized will remain unaffected.
134. The Commissioner contended that he could reallocate partnership income in
proportion to capital and services rendered to the partnership. See I.T. 3845, 1947-1
Cum. Bull. 65; Min. No. 6767, 1952-1 Cum. Bull. 111. However, prior to 1951 the
courts generally did not approve this position. See, e.g., Hartz v. Commissioner, 170
F.2d 313 (8th Cir. 1948); Canfield v. Commissioner, 168 F.2d 907 (6th Cir. 1948);
Woolsey v. Commissioner, 168 F.2d 330 (6th Cir. 1948); but see, Weiss v. Johnson, 206
F.2d 350 (2d Cir. 1953) (reallocation endorsed in a proper case).
in the case where a partnership interest is created by gift. Normally, income will be allocated according to the terms of the partnership agreement, but the Commissioner is now authorized to check abuses in the use of the family partnership through attempts to deflect income away from the properly taxable person by improper allocation of partnership income. Deflection of income occurs to the extent that the donee-partner’s share of income does not make allowance for reasonable compensation to the donor for services rendered to the partnership and to the extent that the portion of the partnership income attributable to the donee’s capital interest is proportionately greater than the portion attributable to the donor’s capital interest.

Where the Commissioner decides that a proper case exists for disregarding the allocation under partnership agreement, he redetermines an allocation of income which he feels more reasonably reflects the respective income-producing contributions of each partner. The Commissioner, in effect, rewrites the contract between the partners by initially determining a reasonable allowance for the services rendered by the donor and then apportioning the balance of the income, if any, to the donor and donee in accordance with their respective interests in partnership capital. In determining a reasonable allowance for services rendered by a partner, consideration will be given to such criteria as the skill, experience, and success of the individual in question, the managerial responsibility assumed by the partner, compensation normally given for such

135. See Stanback v. Commissioner, 271 F.2d 514, 518 (4th Cir. 1959). While § 704(e)(1) provides for recognition as a partner for any person who owns a capital interest in a partnership in which capital is a material income-producing factor, regardless of whether the interest was derived by purchase or gift from any other person, § 704(e)(2) limits the Commissioner’s authority to reallocate income in disregard of the provisions of the partnership agreement to cases where the partnership interest is created by gift. See George A. Paul, 26 P-3 H Tax Ct. Memo 640 (1957). However, § 704(e)(3) expands the reallocation possibility by treating partnership interests purchased by one family member from another as if the transaction were a gift. The “family” of any individual for purposes of § 704(e)(3) includes “only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.” The reallocation provisions also apply in cases where the gift was indirect rather than direct. Treas. Reg. § 1.704-1(e)(3)(ii)(a) (1956).

136. However, the Code and regulations make it clear that, where a partner has rendered services to a partnership prior to entering military service, the Commissioner may not diminish the partner’s distributive share because of such absence. INT. REV. CODE of 1954, § 704(e)(2); Treas. Reg. § 1.704-1(e)(3)(i)(d) (1956).

137. While § 704(e)(2) speaks only in terms of ensuring a reasonable allowance for donor’s services, the regulations state that a reasonable allowance must also be attributed to the services rendered by the donee. Treas. Reg. § 1.704-1(e)(3)(i)(b) (1956).


services in similar businesses, and the cost of securing equivalent services from a person not having an interest in the partnership. Perhaps the best evidence of reasonable compensation for any particular services is evidence of salaries paid to other persons performing similar services in similar businesses in the same locality. Where the services are rendered by a general partner in a limited family partnership, the Commissioner must also consider, in determining a reasonable compensation, that a general partner, unlike a limited partner, risks unlimited personal liability.

IV. CONCLUSION

The development of the federal income taxation of family partnerships reflects the tensions between the efforts of taxpayers to distribute the impact of taxation among close family members without substantially relinquishing control over income-producing property and the attempts of the Commissioner and Congress to insure that income from personal services will be taxable to the person rendering the services and income from property will be taxable to the substantial owner of the property. The decisions prior to 1951 clearly indicate that in the examination of many family partnerships there was a preoccupation with their effect on the revenue, rather than with the purpose of determining whether a real partnership interest had been created in the challenged partner.

Today family partnership law has emerged from the reigning confusion of the late 1940's. Although there is yet no magic formula for establishing a family partnership which accomplishes all the objectives of dollar-conscious taxpayers and also ensures recognition for federal income tax purposes, the present requirements are more clearly defined and the judicial treatment is relatively more predictable.

The family partnership device continues to be of value for income tax purposes and can be safely availed of in the future, provided prudence is exercised and no significant factor, favorable or unfavorable, is left unconsidered. Great pains should be taken to establish the reality of ownership of all capital interests and the bona fides of the relation-

141. Ralph C. Gorrill, 32 P-H Tax Ct. Memo 910 (1963) (a study revealed that normally compensation for the type of services involved ranged from 5-10 per cent of the gross income of a business).
143. See Jelindo A. Tiberti, 31 P-H Tax Ct. Memo 1058 (1962); Ralph C. Gorrill, 32 P-H Tax Ct. Memo 910 (1963). The allocation required under § 704(e)(2) may produce an interesting twist—the Commissioner and the taxpayer will reverse their traditional positions concerning the adequacy of compensation for personal services.
ship in general. Carefully prepared written agreements according due weight to contributions of capital and service and supported by actual conduct will go a long way toward accomplishing the desired results.