

FAMILY PARTNERSHIPS AND THE REVENUE ACT OF 1951

Tax avoidance through intra-family transfers of income is one of the most troublesome problems under the Revenue Act. Given progressive tax rates, substantial tax savings are possible if a single income, subject to a high rate, can be split into several parts so that each is taxed at a lower rate. Family heads have therefore used a variety of devices—assignments, trusts, partnerships and close corporations—in an effort to scatter income among family members.¹ Because it is easy to create and manage, the family partnership has been one of the most popular instruments for income deflection.² Before 1948, wives or children were usually chosen as partners, and credited with part of the income of the husband's business.³ The 1948 Revenue Act permitted all husbands and wives to split income whether a partnership existed or not.⁴

1. For a summary of these devices and their development, see statement of the Treasury Department in *Hearings Before The House Committee on Ways and Means on Revenue Revisions, 1947-48*, 80th Cong. 1st Sess. 866-74 (1947).

2. See tables and cases cited in *Hearings Before House Committee on Ways and Means on Revenue Revisions, 1947-48*, 80th Cong. 1st Sess. 945-6 (1947) for an indication of the amount of litigation that arose even during the short period analyzed. From 1939 to the beginning of World War II, the number of family partnerships steadily increased. During that time there were about 290,000 such partnerships in America. By 1948, there were 930,000. For the year 1947 returns from partnerships indicated family participation in 30 per cent of the cases. 97 Cong. Rec. 12427 (Sept. 26, 1951).

Another reason for the use of partnerships is that they have proved one of the most difficult devices to regulate under the income tax laws. For purposes of computing net income and amortization deductions, partnerships are recognized as economic entities. INT. REV. CODE §§ 183, 190. But for other purposes the entity is disregarded and the partners are treated individually. *E.g.*, INT. REV. CODE §§ 181, 182. This inconsistent treatment of the partnership has produced judicial confusion, and this confusion gave early tax-induced family partnerships a good chance of achieving tax reduction. See Edward B. Archbald, 27 B.T.A. 837 (1933), *aff'd*, 70 F.2d. 720 (2d Cir. 1934), *cert. denied*, *Helvering v. Archbald*, 293 U.S. 594 (1934).

For a discussion of the problems which arise in taxing partnerships generally, see Brookes, *The Strange Nature of the Partnership Under the Income Tax Law*, 5 TAX L. REV. 35 (1949), and Rabkin & Johnson, *The Partnership Under the Federal Tax Law*, 55 HARV. L. REV. 909 (1942).

3. See *Commissioner v. Tower*, 327 U.S. 280 (1946); *Lusthaus v. Commissioner*, 327 U.S. 293 (1946). See also Surrey, *Federal Taxation of the Family—The Revenue Act of 1948*, 61 HARV. L. REV. 1097, 1111 (1948).

4. 62 STAT. 110 (1948), 26 U.S.C. § 301 (Supp. 1951). The husband-wife split income provision of 1948 was Congress' answer to the serious inequity which then existed between married taxpayers in community property states and those in Common Law states. *Hearings Before House Committee on Ways and Means on Revenue Revisions, 1947-48*, 80th Cong., 1st Sess. 10, 70, 748-84 (1947). In *Poe v. Seaborn*, 282 U.S. 101 (1930), the Supreme Court had held that the earnings of a married couple in a community property state were taxable half to each, regardless of who actually earned them. In Common Law states, however, the person who earned the income paid the tax and no husband-wife split was allowed. The result was a series of protests in the Common Law

Since then, taxpayers have sought further tax reduction by making their children partners.⁵ Judicial attempts to distinguish transfers made solely for tax purposes from those made to form valid partnership interests have resulted in one of the longest and most vexing disputes in the history of the income tax law.

FAMILY PARTNERSHIPS BEFORE 1951

Family partnerships even if formed merely for tax avoidance were generously treated by the courts before 1930.⁶ If the partnership was recognized under local law, the court was satisfied. The Supreme Court decision in *Lucas v. Earl*,⁷ however, marked a change in judicial attitudes toward family transfers. Earl had attempted to assign part of his income to his wife. In holding that all the income must be taxed to the one who had earned it, Mr. Justice Holmes started a trend toward judicial skepticism of all family transfers.⁸ Courts began to inspect more closely partnerships questioned by the Commissioner;

states and the utilization of intra-family transfers—among them the family partnership, with the wife as a partner—in an attempt to achieve the tax savings enjoyed by the residents of community property states. *Hearings Before House Committee on Ways and Means, supra* at 801, 805.

A second reason for the husband-wife split-income amendment was the confusion and disputes that were arising from intra-family transfers. For a full discussion of the problems and the 1948 amendment, see Surrey, *Family Income and Federal Taxation*, 24 TAXES 980 (1946), and Surrey, *Federal Taxation of the Family—The Revenue Act of 1948* 61 HARV L. REV. 1097 (1948). For an explanation of the origin of the community property system in America, see *Hearings Before House Committee on Ways and Means, supra*, at 813-23.

5. See Burton, *Family Partnerships and the Income Tax—The Culbertson Chapter*, 98 U. OF PA. L. REV. 143, 144 (1949).

6. *Meeham v. Valentine*, 145 U.S. 611 (1892), set up three prerequisites for a valid partnership: (1) joint endeavor for common benefit, (2) each party must contribute either capital or services, (3) the parties must have a community of interests in the profits. Later decisions, however, tended to disregard the *Meeham* requisites. *Elihu Clement Wilson*, 11 B.T.A. 963 (1928) (oral partnership agreement between three married couples upheld, although wives contributed neither capital nor services); *C. W. Crane*, 19 B.T.A. 577 (1930) (partnership created with daughters by gift to them of father's partnership interest upheld) and *J. E. Briggs*, 15 B.T.A. 1092 (1929) (taxpayer's partnership with wife and sons upheld when neither wife nor sons contributed capital and where only one of the two sons contributed services).

7. 281 U.S. 111 (1930).

8. In disposing of the taxpayer's argument that he and the wife contracted to own jointly the earnings of either one, Justice Holmes stated that "There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken . . . by which the fruits are attributed to a different tree from that on which they grew." *Id.* at 114-5. For an analysis of the effect of *Lucas* on subsequent decisions, see Surrey, *Family Income and Federal Taxation*, 24 TAXES 980 (1946).

by 1940, courts were striking down partnerships tax-wise as consistently as similar partnerships had been upheld before.⁹

In 1946, when the case of *Tower v. Commissioner*¹⁰ reached the Supreme Court, lower courts were seeking objective standards to judge the validity of family partnerships. The *Tower* case involved a husband-wife partnership where the wife performed no services and where her capital contribution had originally been given her by the husband. The Court held the partnership inoperative for tax purposes.¹¹ Lower courts read the *Tower* opinion as requiring either an original capital contribution by the wife or performance of vital services for partnership validity.¹² But the search for criteria was not over. In 1949 *Culbertson v. Commissioner*¹³ held that the *Tower* case had been misread: The partners' *intent* to form a genuine partnership was the controlling criterion. Original capital contribution and vital services were important but not final considerations. After *Culbertson*, lower courts continued to look primarily for capital contributions or services, but since a subjective standard now determined the result in each case, decisions were unpredictable and widely divergent.¹⁴

9. Compare L. S. Cobb, 9 B.T.A. 547 (1927) with *Blalock v. Allen*, 56 F. Supp. 266 (D. Ga. 1944) and *Mullard D. Olds*, 15 B.T.A. 560 (1929), *aff'd*, 60 F.2d 252 (6th Cir. 1932) with *R. W. Camfield*, 3 T.C.M. 123 (1944).

10. 327 U.S. 280 (1946).

11. In denying the existence of the partnership for tax purposes, the Court stated that "a partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a... business and where there is a community of interests in the profit or losses. 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 on business and sharing in the profits or losses, or both. And their intention... is a question of fact, to be determined from testimony disclosed by their agreement, considered as a whole, and by their conduct in execution of its provisions..." *Id.* at 286-7. *Lusthaus v. Commissioner*, 327 U.S. 293 (1946) was decided the same day as the *Tower* case. The court there held invalid for tax purposes a husband-wife partnership where the wife performed incidental services but took no part in the management and where the alleged sale to her of a capital interest in the partnership was held to be a sham.

12. *Q. I. Roberts*, 8 T.C.M. 60 (1949) (petitioner's wife held not a partner for income tax purposes because she did not render sufficient services to the partnership). *Charles A. Carolin*, 8 T.C.M. 548 (1949), *aff'd. per curiam*, 181 F.2d 186 (6th Cir. 1950) (wife assisted husband with clerical work on weekends and evenings; court found services not "vital" and since wife merely helped out, she was not recognized as a partner). *Sol. M. Flock*, 6 T.C.M. 945 (1947) (where wife contributed only gift capital from husband and performed no services for the business, no partnership existed for tax purposes).

13. 337 U.S. 733 (1949).

14. See *Ardolina v. Commissioner*, 186 F.2d 176 (3d Cir. 1951) *reversing* 8 T.C.M. 1111 (1949) where appellate court did not regard as important the fact that the wife's contribution to the partnership came to her as a gift from her husband. Compare also the problems presented in *Florence R. Miller*, 8 T.C.M. 26 (1949), note 32 *infra*. See H. R. REP. NO. 568, 82d Cong., 1st Sess. 32-3 (1951). See also, *Burton, Family Partnerships and the Income Tax—The Culbertson Chapter*, 98 U. OF PA. L. REV. 143 160 (1949) and Note, *Income Taxation of Family Partnerships*, 50 COL. L. REV. 68 (1950).

THE 1951 ACT

To settle the problems raised by judicial administration of *Culbertson*, and with an eye toward reducing the interminable number of court disputes on the subject, Congress in 1951 set its own standards for recognition and taxation of income of family partnerships. Congress' declared objective in the new statute was to harmonize the rules governing interests in family partnerships with those generally applicable to other forms of property or business: to tax income from property to the real owner, and to tax income from services to the person rendering the services.¹⁵ Accordingly, Congress added the following sentence to the definition of "partnership" in Section 3797 of the Internal Revenue Code:

"A person shall be recognized as a partner for income tax purposes 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."¹⁶

Congress also added as Section 191 of the Code the following provision:

"In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service. For the purpose of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The 'family' of any individual shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons."¹⁷

Thus, in the case of partnerships where income is in part produced by capital, Congress wiped out *Culbertson's* intent criterion as well as the factual

15. *Report of the House Ways and Means Committee on Revenue Act of 1951*, H. R. REP. No. 586, 82d Cong., 1st Sess. 32 (1951): "There is no reason for applying different principles to partnership income. If an individual makes a bona fide gift of real estate, or a share of corporate stock, the rent or dividend income is taxable to the donee. Your committee's amendment 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. If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of a new partner."

16. Pub. Law No. 183, 82d Cong., 1st Sess. § 340(a) (Oct. 20, 1951).

17. *Id.* § 340(b).

standards of *Tower*. The amendment substitutes a blanket rule that all partnerships are good, no matter how created, if there was an actual transfer of a capital interest.

To cope with attempted tax avoidance where one or more partnership interests was obtained by gift or purchase from a family member, the amendment provides for reallocation of income. If the partnership agreement distributes income without providing a reasonable allowance for services contributed by the donor, or if the donee gets proportionately more for his capital than the donor gets for his, the Commissioner may to that extent increase the share of income credited to the donor.

Proposals for a legislative solution to the family partnership dispute had previously been made in 1948 and 1950.¹⁸ The 1951 provision is a combination of the earlier proposals. Usually the text of tax legislation is a synthesis of many well advised views, worked over by four different Washington staffs.¹⁹ But in the legislative haste to put over a family partnership amendment, little attention was given to the text of the amendment itself, except by its own particular group of sponsors.²⁰ The result is a statute that will probably breed litigation without solving the family partnership problem.

PROBLEMS OF DEFINITION

The first question raised by the new amendment is what type of partnerships and partners will now be recognized. Section 3797 states that in partnerships where capital is a "material income-producing factor" any person owning a capital interest is a partner, no matter how the interest was acquired. The major problems are (1) the effect of the section on personal service partnerships; and (2) whether trusts can be partners.

Personal Service Partnerships

It seems clear that 3797 covers any partnership with some invested capital. Even where the amount of capital is small, it can, along with services, be one of the recognized income-producing factors of the enterprise.²¹ But the a-

18. The 1948 suggestions were included with proposals for the husband-wife split income provision. The adoption of the split income amendment was accepted as a partial solution to the partnership problem since most family partnership litigation up to that time involved husband-wife transfers. *Hearings Before House Committee on Ways and Means*, note 4 *supra*, at 801, 967. In 1950, Senate-sponsored action on family partnerships was defeated by the House. 2 U.S. CODE CONG. SERV. 3264 (1950). The 1950 Senate proposal, however, was substantially the basis for the 1951 amendment. Compare SEN. REP. No. 2375, 81st Cong. 2d Sess. 60-3 (1950) with SEN. REP. No. 781, 82d Cong., 1st Sess. 38-41 (1951).

19. Communication to the YALE LAW JOURNAL from Eugene Bogan, Sharp, O'Connor & Bogan, Washington, D.C.; dated January 3, 1952, on file in Yale Law Library.

20. *Ibid.*

21. Whether capital is a material income-producing factor is a factual question to be determined in each case by a consideration of the type of business, the total amount of capital invested, the use made of capital, the relationship of income to services and

ment does not apply to a partnership where there is no capital or where capital is an inconsequential income-producing factor.

Typically, personal service partnerships are formed by professional men, each of whom contributes services alone to the business. Sometimes they join together to hire younger specialists as assistants. Engineering, stock brokerage, law or architectural firms are examples. Some family partnerships of this type were recognized under *Culbertson* if each member contributed services and a real business intent to form a partnership was proved.²² Does 3797 mean that a valid family partnership cannot be created by the contractual transfer of a partnership interest, without the transfer of actual capital? Congress' failure to mention personal service partnerships probably does not indicate an intention to deny tax validity to arrangements which were valid under the old law. These partnerships have been consistently recognized for tax purposes;²³ had Congress intended to change this settled law it would surely have done so explicitly.

Assuming the continued recognition of personal service partnerships, can an interest in such a partnership validly be created by gift? Clearly, courts will refuse tax recognition to assignments of income from services.²⁴ But suppose an engineer has an established personal service business, with a number of

similar factors. See U.S. Treas. Reg. 111 § 29.25-2 (1944), and Packel, *The Next Inning of Family Partnerships*, 100 U. OF PA. L. REV. 153, 159 (1951).

In *Greenberger v. Commissioner*, 177 F.2d 990, 994 (7th Cir. 1949), the Court of Appeals, in reversing a Tax Court decision which had held that capital was not a material income producing factor, 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 in connection with the available income which the partnership had."

The problem arises also where for excess profits tax purposes, courts must decide whether capital is a material income producing factor for a particular corporation. See CCH EXCESS PROFITS TAX REP. ¶ 55,066 (3d ed.) for the criteria used in this determination.

22. *Larson v. Kraemer*, 84 F. Supp. 313 (D. Conn. 1949) (valid personal service partnership existed between husband and wife who worked together in building a school business). See also *Roy C. Fleeman v. Commissioner*, 7 T.C.M. 770, 774 (1948) (husband-wife personal service insurance business recognized as bona fide partnership for tax purposes where both contributed "efforts, industry and skills").

23. *J. A. Mount v. Commissioner*, 5 T.C.M. 1004, 1007-8 (1946) (wife who performed valuable services in business largely of a personal service nature recognized as a partner). See also *Lawrence M. Hirsig, et al. v. Commissioner*, 4 T.C.M. 848, 851 (1945) and *Peter F. Loftus v. Commissioner*, 3 T.C.M. 974, 981 (1944).

24. *Lucas v. Earl*, *supra* notes 7, 8. *Burnet v. Leininger*, 285 U.S. 136, 139-40 (1932) (purported transfer of half of husband's partnership interest to wife held inoperative and income from this interest taxed to husband). The *Leininger* case, however, rested its findings on the invalidity of the transfer of a partnership interest. There was no showing that other partners had consented, and there was apparently no change in ownership of partnership assets or controls.

The courts have generally accepted the view expressed in *Commissioner v. Sunnen*, 333 U.S. 591, 604 (1948) that "as long as the assignor actually earns the income or is otherwise the source of the right to receive and enjoy the income, he remains taxable."

employees. The business has profits which result from the combined labor of its workers and from its reputation as a going concern,²⁵ apart from the taxpayer's salary. He might contend that he can make his son a partner and that the son is entitled to "going concern profits" as an owner of a part of the capital interest²⁶ in the partnership. True, there is only a negligible amount of invested capital, but the taxpayer can maintain that a partner need own no capital apart from ownership of a portion of the partnership interest. And the son can claim he has an interest in capital assets as they accumulate.²⁷ Section 3797, however, validates only gift partnerships where capital is a material income-producing factor. But the taxpayer may argue that, in passing the new amendment, Congress indicated that its primary intent was to recognize every valid gift of a partnership interest.²⁸

If this type of partnership were recognized, it should be subject to income reallocation under 191, which applies to all partnerships created by gift. Thus, income attributable to the going concern would be credited for tax purposes in proportion to each partner's ownership of an interest in the business.

Trust Partners

Prior to 3797, courts would not uphold attempts to split income by making a trust a partner. The "intent" criterion of *Culbertson* was used to strike down partner-trusts which contributed no services and whose capital contribution resulted from a gift by the partner-grantor.²⁹ But the word "person" in 3797

25. See Robinson, *The Allocation Theory in Family Partnership Cases*, 25 TAXES 963, 970 (1947).

26. Cf. *Commissioner v. Shapiro*, 125 F.2d 532, 535 (6th Cir. 1942); "Respondent sold all of his interest in the partnership, tangible and intangible, as a going concern, which in all essentials is different from the ordinary assets of the partnership used in the usual course of its business." The Commissioner has recognized a partnership interest as a capital asset, and the gain or loss realized on the sale of such an interest as a capital gain or loss. See G.C.M. 26379, 1950-1 CUM. BULL. 58.

For an accounting treatment of the partnership basis after the interest of a partner has been sold for more than his capital investment, see Spencer, *Tax Consequences Arising from Purchase of Partnership Interest: A Question of Basis*, 91 J. ACCOUNTANCY 116 (1951). The capital interest in a partnership is here recognized as an entity apart from the underlying assets of the partnership.

27. MECHEM, ELEMENTS OF PARTNERSHIP, 16-17 (1920); LITTLE, FEDERAL INCOME TAXATION OF PARTNERSHIPS, 16-17 (1952).

28. H. R. REP. NO. 586, 82d Cong., 1st Sess. 32 (1951): "Your committee's amendment 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."

29. *Kohl v. Commissioner*, 170 F.2d 531 (8th Cir. 1948), cert. denied, 337 U.S. 95b (1949) (gift in trust of interest in family partnership held inoperative for tax purposes when it made no real change in the economic situation of the group or in the management of the business); *W. B. Woolsey v. Commissioner*, 5 T.C.M. 1038 (1946) (where wife was trustee-partner of trust for children set up by gift from husband, husband taxed on trust income since no family partnership recognized). *Lily Ho Quon v. Commissioner*, 6 T.C.M. 348 (1947), aff'd, 165 F.2d 215 (9th Cir. 1948) (trusts for children established by husband and wife denied recognition as partners).

includes trusts as well as natural persons.³⁰ Hence under the new amendment valid trusts set up by gift will now be recognized as partners because the trust corpus constitutes the required invested capital in the partnership. This recognition might appear to open a wide loophole for family tax scattering. For example, a father with one son can make him a partner and give him one-third of the partnership assets. Then the father can set up a trust with the son as beneficiary, and make the trust a partner. Partnership income will be split three rather than two ways, and less taxes will be paid.

There are, however, several crucial restrictions on this method. First, since the *Clifford*³¹ decision in 1940, the Commissioner can invalidate trusts for tax purposes in a variety of situations where the grantor retains one or another form of control over the trust corpus or income.³² Second, the trust must be an accumulation trust with the income not currently distributable to

30. "The term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, company or corporation." INT. REV. CODE § 3797(a)(1).

31. *Helvering v. Clifford*, 309 U.S. 331 (1940).

32. U.S. Treas. Reg. 111, § 29.22(a)-21 (1947). Trusts invalidated where grantor retained control: *S. Kenneth Alexander v. Commissioner*, 6 T.C.M. 804 (1946) (trust for wife where husband retained control over trust income held taxable to husband); *Henry F. Haldeman v. Commissioner*, 6 T.C.M. 345 (1946) (trust income taxable to trustee where husband and wife set up five family trusts, retaining control of each as trustees). *But cf.* *Armstrong v. Commissioner*, 143 F.2d 700 (10th Cir. 1944) (father-trustee of trust set up for children, through retaining broad controls, held not taxable on trust income since trust was irrevocable and not for benefit of father). Revocable or short term trusts invalidated: *Commissioner v. Lamont*, 127 F.2d 875 (2d Cir. 1942); *Central National Bank of Cleveland v. Commissioner*, 141 F.2d 352 (6th Cir. 1944).

Valid trusts under the Clifford regulations have frequently failed as partners where no business intent to form a partnership was proved. See: *Florence R. Miller v. Commissioner*, 8 T.C.M. 26 (1946). A husband-wife partnership was here held invalid under the *Tower* case criteria of capital and services. Several trusts set up for three children, with the parents as trustee-partners, were also invalidated. The years in question were 1940-1942. The parents' aim was to split income five ways, between the taxpayer, his wife and the children's trusts, while the parents as trustees retained full control of the business. On appeal from the Tax Court, the Sixth Circuit held that under *Culbertson*, decided after the Tax Court opinion in the *Miller* case, the husband and wife had formed a valid partnership. Three of the children's trusts which had been created by gift from the taxpayer's father were upheld, and the case was remanded for a determination of the validity of the partner-trusts created by gifts from the taxpayer. *Florence R. Miller v. Commissioner*, 183 F.2d 246 (6th Cir. 1950) The Tax Court finally decided that the broad control which the parents continued to exercise over the funds and management of the partnership indicated "that in making the alleged transfers to themselves as trustees for their minor children... (they) did not intend to form a real business partnership with the children or with themselves as trustees for the children." *Florence R. Miller*, 2 P-H. 1951 TC MEM. DEC. 11424 (1951).

Basic policies for the treatment of family trusts for tax purposes were laid down in *Corliss v. Bowers*, 281 U.S. 376 (1930) (income from revocable trust set up for wife; grantor-husband retained extensive controls. Held taxable to husband); *Burnet v. Wells*, 289 U.S. 670 (1933) (income from one of five irrevocable trusts established by grantor-father, which was used indirectly for benefit of grantor, held taxable to him); *Fulham v.*

the beneficiary if the trustee is to pay the tax.³³ Once he has done so, the income is not taxed again when later distributed to the beneficiary. Such an arrangement means that the income credited to the trust is unavailable to the beneficiary during the years it accumulates. But this income can be retained in the business or otherwise invested for the beneficiary, and may be as valuable to him as if distributed.

Despite these limitations, under the new law it will often be highly advantageous to establish a trust-partner. For a young child, several trusts might be established, of different durations.³⁴ These would probably be taxed as a single trust entity.³⁵ But they would produce a single split in income now,

Commissioner, 110 F.2d 916 (1st Cir. 1940) (trust income taxable to grantor when grantor retained, through parties not having a substantial adverse interest, practical control of the trust corpus and power to revoke). In the leading trust case, *Helvering v. Clifford*, 309 U.S. 331 (1940), the Supreme Court sustained the tax on the grantor, stating that "where . . . the benefits [from the trust] directly or indirectly retained blend so imperceptibly with the normal concepts of full ownership, we cannot say that the triers of fact committed reversible error when they found that the husband was the owner of the corpus for the purposes of section 22(a) [of the Revenue Act]."

In 1945, the Treasury Department issued the Clifford Regulations in an effort to settle the "considerable uncertainty and confusion" that developed from judicial application of the Clifford doctrine. U.S. Treas. Reg. 111 § 29.22(a)-21 (1947). Generally the Clifford Regulations stated the Treasury view that the income would be taxable to the grantor if (1) the trust or trust income would return to the grantor within a short term of years, (2) if the grantor retained substantial control over the trust corpus or trust income, or (3) if the trust or trust income were subject to administrative control exercised for the benefit of the grantor. *Ibid.* See also 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 37.17 *et. seq.* for a detailed treatment of the Clifford doctrine.

33. *Plimpton v. Commissioner*, 135 F.2d 482, 485 (1st Cir. 1943): "[T]he statute taxes income which is to be distributed currently, whether actually distributed or not, to the beneficiaries, but taxes income to the fiduciary which may in his discretion be either distributed or accumulated, excepting only such part thereof as may have been actually distributed in any year, which part it taxes to the beneficiary. The scheme of the statute . . . is not to tax income to a beneficiary which he is not entitled to receive. . . ."

Nor can the income be distributed at the discretion of the beneficiary if he is to avoid paying the tax. *Bunting v. Commissioner*, 164 F.2d 443 (6th Cir. 1947) *affirming* 5 T.C.M. 704 (1946) (one of three beneficiaries held taxable on all of the trust income where the instrument gave the beneficiary the power to amend the trust "in any respect whatsoever," including the right to name himself sole beneficiary and withdraw all or any of the corpus. *But cf.* *Allen v. Nunnally*, 180 F.2d 318 (5th Cir. 1950) where a grantor created a trust for his grandchildren, naming a corporate trustee, but giving his son the power to revoke, alter or amend the trust in any way, including a change of trustee or beneficiary. On the ground that the son held this power in a fiduciary capacity, which would forbid naming himself as beneficiary, the son was held not taxable on the trust income.

34. Trusts of different durations would be advantageous in that they would release, at different expiration dates, income to the beneficiaries.

35. *Spies v. United States*, 180 F.2d 336 (8th Cir. 1950) *affirming* 84 F. Supp. 769 (N.D. Iowa 1949). (Where three children who were trustees and equal beneficiaries had power to distribute the trust income to themselves or accumulate it, they were held taxable

reduce present taxes, and provide a fund of tax-free income for planned intervals in the future. To set up the same savings plan under *Culbertson*, the grantor would first have to pay a tax on the total income. Under the new legislation, savings can be accumulated and a tax advantage gained at the same time.

REASONABLE COMPENSATION AND PROPORTIONAL CAPITAL CONTRIBUTION

Section 191 now guarantees recognition of family transfers which might have failed under the intent test of *Culbertson*. But it also authorizes the Commissioner to reallocate income for tax purposes where such reallocation was not previously allowed once a valid partnership was proved.³⁶ Congress apparently intended that for family partnerships created by gift, the income would be taxed as if a reasonable allowance for services had been made to the partners, and as if the balance of profits had been allocated according to the amount of capital the partners had invested.³⁷ The wording of the statute, however, is vague enough to afford both Commissioner and taxpayer opportunity to argue for other allocations which will be more to their advantage.

Commissioner's Argument

The Commissioner will begin his efforts by attempting to set the value of the donor's services as high as possible. This will require him to adopt an opposite line of attack from that used in many closely held corporation cases.

on the undistributed income. Although no one beneficiary had "unfettered command" of the income, the court considered all three in effect "a single trust entity."). *But cf.* *Allen v. Nunnally*, 180 F.2d 318 (5th Cir. 1950), *supra* note 33.

36. INT. REV. CODE §191. This statutorily granted power to reallocate income is not the first time reallocation has been permitted. In *Woolsey v. Commissioner*, 168 F.2d 330 (6th Cir. 1948) and *Canfield v. Commissioner*, 168 F.2d 907 (6th Cir. 1948), the court, in recognizing two husband-wife partnerships, denied income reallocation contrary to the partnership agreement. Both opinions, however, apparently recognized the power of the Tax Court to reallocate income in cases where a valid partnership was found but the income distribution was inequitable. *Hartz v. Commissioner*, 170 F.2d 313, 318 (8th Cir. 1948) held that since a valid partnership existed, "[t]he Tax Court had no right to reapportion the income of the partnership between the partners for tax purposes." The *Hartz* decision did not answer the problem whether in some cases, partnership income might be reallocated by the Commissioner. The *Culbertson* case avoided the reallocation problem: "No question as to the allocation of income between capital and services is presented in this case, and we intimate no opinion on that subject." *Commissioner v. Culbertson*, 337 U.S. 733, 748 (1949). Despite this implicit recognition of the Tax Courts' power to reallocate income in cases where recognized partnerships disproportionately distribute it, no court since the *Hartz* decision has allowed reallocation. For a discussion of the few decisions where the issue was raised, see 2 P-H 1951 FED. TAX SERV. ¶ 15,522.

The Treasury, however, has consistently argued that it should be allowed to reallocate income in proportion to capital invested and services rendered. I.T. 3845, 1947-1 CUM. BULL. 66, 68.

37. H. R. REP. NO. 586, 82d Cong., 1st Sess. 34 (1951).

Recognizing the possibility that income of closely held corporations may be reduced or exhausted by salaries of officer-stockholders, the Commissioner has frequently attempted to decrease such allowances in order to tax more profits.³⁸ Although the Commissioner's arguments may thus appear inconsistent, his position is not unreasonable in view of the fact that both family corporations and family partnerships may be tax avoidance devices. Nevertheless he must find a convincing theory for treating differently functionally equivalent compensation.

Since Section 191 does not define "reasonable compensation," the Tax Court will probably look for interpretative assistance to decisions under the "reasonable allowance" clause of Section 23(a)(1) of the Revenue Code, the section applicable to corporate officers' salaries.³⁹ Courts determine a reasonable allowance under Section 23 by an *ad hoc* consideration of all the facts in each case, the most acceptable proof being a comparison with salaries for like positions in firms of similar size in the same industry.⁴⁰ In order to treat partnership and corporate salaries differently, the Commissioner will probably argue that "reasonable compensation" under 191 cannot be determined by the criteria used in finding a "reasonable allowance for salaries" under 23(a)(1). The difference in language, so the argument runs, shows that Congress did not intend to make the two standards equivalent. On the contrary, the Commissioner will maintain that while the standard of 23(a)(1) is the value services would have on the open market, "reasonable compensation" in a partnership

38. Note, *The Deduction of a Reasonable Allowance for Salaries—The Undefined Power of the Commissioner*, 56 HARV. L. REV. 997 (1943). See also Note, *New Light on a Reasonable Allowance for Salaries*, 59 HARV. L. REV. 286 (1945) and Wolder, *Facts and Figures on Reasonable Compensation*, 24 TAXES 150 (1946).

Salaries are deductible for tax purposes only if they are "reasonable" within the meaning of § 23(a)(1)(A). See note 39 *infra*. The Commissioner therefore frequently attempts to disallow the deduction by proving that the salary paid is unreasonable. Thus, in *Long Island Drug Co. v. Commissioner*, 111 F.2d 593 (2d Cir. 1940), *cert. denied*, 311 U.S. 680 (1940) a family corporation paid its officers both a fixed sum and a percentage of profits as salary. The court allowed the taxpayer-officers to deduct only the fixed sum as a business expense.

39. Section 23 states that: "In computing net income there shall be allowed as deductions . . . [a]ll the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a *reasonable* allowance for salaries. . . ." INT. REV. CODE § 23(a)(1)(A) (emphasis added).

40. *Faucette Co., Inc.*, 17 T.C. 187, 196 (1951) ("evidence of salaries paid for similar services by comparative businesses . . . is recognized as one of the most satisfactory tests [of reasonableness]").

These factors may include: an employee's qualifications, the extent and scope of his work, prevailing rates of compensation, the size of the business, the ratio of salaries to gross income, general economic conditions, salaries paid in previous years, expert opinion testimony and in some cases a comparison of salaries with distributions to stockholders. For a full explanation of these criteria, see 4 MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 25.51, 25.62 (1942).

includes an additional amount in recognition of the firm's profits as a going concern.⁴¹

If the Commissioner is successful, however, the court must seek a formula for determining the reasonable *value* of the donor's services. The Commissioner will probably want to allocate the entire partnership income to capital and services. Such a formula has been used to meet the needs of community property cases where the reasonable value of the husband's services had to be computed to separate community income from income earned by separately invested capital.⁴² This formula, embodied in G.C.M. 9825, offers an approved method for determining the donor's value to a partnership, measured by a percentage of partnership profits.⁴³ Assume a partnership earns \$100,000 annually. Assume further that under the criteria of Section 23 \$36,000 would

41. The Committee Reports for the 1951 Bill speak only of "reasonable compensation for services" and a "reasonable allowance for services" without further defining Congressional intent. SEN. REP. No. 781, 82d Cong., 1st Sess. 40 (1951); H. R. REP. No. 586, 82d Cong., 1st Sess. 34 (1951). But the Senate Finance Committee Report for 1950, from which the later reports were drafted, states that the proportionate value of the services of family members of a partnership must be allocated for tax purposes. SEN. REP. No. 2375, 81st Cong., 2d Sess. 62 (1950). The Commissioner may maintain with some justification that the 1950 wording expressed Congress' intent that the value of the donor's services measured by the profits of the going concern be allocated to him, and that the 1951 reports indicate no change in Congressional intent.

Section 222 of the Senate's proposed 1950 law used the term "reasonable proportionate allowance" to describe the amount to be allocated to the donor's services. It is also evident that in 1951 the Senate Finance Committee at least was aware that confusion might result if the statute did not clearly state whether a "reasonable salary" or "the reasonable proportionate value of services" was intended for allocation purposes. See *Hearings, Senate Committee on Finance on Revenue Act of 1951*, 82d Cong., 1st Sess. 1830 (1951). The lack of a distinction in the 1951 law and its Congressional reports, coupled with the notice of possible confusion and the colorable intention expressed in the 1950 bill and reports makes the Commissioner's argument at least plausible, if not compelling.

42. In community property states, income earned by the services of the husband was considered community income and taxed half to the husband and half to the wife. Income from separately invested capital—for example, capital invested either by husband or wife before marriage—was not considered community income and was taxed entirely to the owner of the investment. If the husband was a member of a partnership before marriage and continued as a member after marriage, his income from services after marriage would be community income; his income from invested capital would be his individual income. G.C.M. 1030, VI-1 CUM. BULL. 26 (1927) established the general Treasury policy for taxing this latter income separately. G.C.M. 9825, X-2 CUM. BULL. 146, 149 (1931) outlined in further detail the method for doing so.

43. G.C.M. 9825, X-2 CUM. BULL. 146 (1931) (hereinafter cited as G.C.M. 9825).

G.C.M. 9825 was approved and applied in *Clara B. Parker*, 31 B.T.A. 644, 658 (1934) (income apportioned between earnings of services and earnings of capital in accordance with G.C.M. 9825). See also *Todd v. Commissioner*, 7 T.C. 399 (1946) (Commissioner's determination of value of father-partner's services under G.C.M. 9825 upheld).

As late as 1947, the Treasury stated that if the courts would allow allocation of partnership income, it would use the method indicated in G.C.M. 9825 for reapportion-

be a reasonable salary for the donor, and that \$24,000 would be a fair return on invested capital.⁴⁴ Under G.C.M. 9825, the Commissioner would then allocate 24/60 of \$100,000 or \$40,000 to capital, and 36/60 of \$100,000 or \$60,000 to services.⁴⁵ If donor and donee had equal amounts of invested capital, the donee would then be taxed on half the income allocated to capital—\$20,000, and the donor would pay taxes on the remaining \$80,000. Thus G.C.M. 9825 apportions business profits percentage-wise, part to services and part to invested capital. Under this theory, Congress' new restrictions are adequate to prevent any deflection of income from the true owner.

If the courts accept this formula, does it mean that income must be apportioned according to profits each year, or can an average annual profit be used as the basis for a long term allocation? If the partnership agreement provides for a fixed return to the donor based on such an average annual profit, it would seem reasonable for the Commissioner to accept for several years at least a single determination under G.C.M. 9825.

Taxpayer's Argument

The taxpayer, on the other hand, can maintain that there is no ground for interpreting "reasonable compensation" in Section 191 to mean anything different from a "reasonable allowance for salaries" under Section 23. Despite the verbal difference, nothing in the Committee reports or legislative history shows that Congress intended a distinction.⁴⁶ And compensation to the partner-donor is functionally the same as salary to a corporate officer. In both partnerships and close corporations, the donor-father is typically the chief income earning figure in the enterprise.

The taxpayer may advance his own allocation proposal by arguing, contrary to the theory of G.C.M. 9825, that profits cannot be allocated rationally between capital and services because some profits are not attributable percent-

ment. I.T. 3845, 1947-1 CUM. BULL. 66, 68. But the weight of authority before the 1951 amendment was against any income reallocation once a partnership was recognized. See note 36, *supra*. See also 2 P-H 1951 FED. TAX SERV. ¶ 15,522 G.C.M. 25642. 1948-1 CURR. BULL. 60 modified a part of G.C.M. 9825 but did not change its general treatment of partnership income. Cf. Estate of S. U. Tilton *et al.* 8 B.T.A. 914, 917 (1927) ("If the partners agree on a proportion distribution of partnership profits, the agreement will be given effect since the courts have recognized the impracticability of determining the relative values of the respective contributions of the individual partners.").

44. A fair return on invested capital may be measured by the reasonable rate of interest on a long term investment, well-secured. *Lawrence Oliver v. Commissioner*, 4 T.C. 684 (1945).

45. The example is taken from G.C.M. 9825.

46. But see note 41, *supra*. The taxpayer may argue that the difference in language between "reasonable compensation" and "reasonable salary" is insignificant and that if Congress had intended a distinction, it would have been clearly stated in the statute. Furthermore, the 1951 Committee reports talk in terms of a "reasonable allowance" and "reasonable compensation" and say nothing about the *value* of a donor to a partnership.

age-wise to either.⁴⁷ Thus, in the previous example, the value of capital (\$24,000) and services (\$36,000) together totalled only \$60,000 out of a \$100,000 income. From where does the extra \$40,000 come? According to the taxpayer's theory of profits, it comes from the partnership as an operating economic enterprise, from the risk of continuous operation and from the reputation and good will accumulated over the period of doing business.⁴⁸ This profit remains after reasonable compensation for services has been made to the partners and after the earnings of invested capital have been proportionately distributed to each contributor of capital. The new law, taxpayers will point out, requires proportional distribution only for the share attributable to capital. It says nothing about the distribution of the profit increment from the going concern. Hence the taxpayer will maintain that the \$40,000 can be allocated any way the partnership agreement provides. The result of his proposal could be that the donee is taxed on the \$40,000 plus the income from his capital, a total of \$52,000, while the donor pays taxes only on the remaining \$48,000. Thus the new law can be read to permit tax avoidance where the donee has provided no services and the profit increment of the operating business results from the past energy and resourcefulness of the donor.

Congressional Intent

In passing Section 191, Congress probably intended that after a reasonable salary had been credited for the services of the donor, the balance of the income would be distributed according to capital holdings.⁴⁹ Thus, using the same example, the donor would be taxed on income from his services plus half the remainder, and the donee would be taxed on the other half. The donee's share would be \$32,000; the donor's \$68,000. Where equal father-son partners establish and build a business, such an allocation of capital earnings is equitable.⁵⁰ But in many family partnership cases this distribution would defeat Congress' primary purpose to tax income to the one who earns it. Suppose a father who has built up a business over many years forms a partnership, giving his son a half interest.⁵¹ Profits, apart from the father's salary, may then be distributed under 191, half to the father, half to the son. But this distribution is equitable only for one year. In the partnership's second year the father will have contributed both his capital and services to maintain the going concern; typically, the son will have contributed only his invested capital.

47. For an explanation of the economic theory of profits and the fallacy of apportioning them on a percentage basis between income attributable to capital and income attributable to services, see Robinson, *The Allocation Theory In Family Partnership Cases*, 25 TAXES 963, 970 (1947).

48. *Id.* at 970.

49. H. R. REP. No. 586, 82d Cong., 1st Sess. 34 (1951).

50. In this situation, each partner has performed equal services and each has invested an equal amount of capital. Therefore, each partner has an equal "interest" in the business, and profits, after compensation for services has been paid, can be equitably split.

51. See note 26 *supra*.

Hence a larger portion of the "going concern profits" is now attributable to the father, and profits can no longer properly be distributed half to the father and half to the son.⁵²

Congress might have found a better solution to the allocation problem if it had recognized that in most family partnerships created by gift the donee is in fact like a limited partner.⁵³ He contributes no managerial services and is probably expected to bear no liability beyond the gift he invests.⁵⁴ For tax purposes, therefore, the donee's income should be limited to a fair return on invested capital. This return might be measured by the income generally received on capital invested in similar industries.⁵⁵ The remaining partnership income would then be credited to the donor.

Under 191, however, a fixed return to the donee on invested capital might not always be allowed. Thus, in high profit years, a 7% return on invested capital might comply with the statute. But in low profit years, a 7% return to the donee might not leave enough profit to satisfy 191 requirements for reasonable compensation to the donor and at least an equal 7% return on the donor's capital. The partnership agreement could provide, however, for a special distribution to comply with 191 in low profit years.

OTHER ASPECTS OF THE ALLOCATION PROVISIONS

Non-partner Donors

Many family partnerships may avoid the allocation restrictions of the new statute without fighting any of the major battles predicted above. Congress

52. Nor can the increased (or decreased) profits from the business, under this theory, be credited each year to the father, since they derive from the continued existence of the going concern, and are not computably related to the father's services. In each successive year, as the father contributes both services and capital to the business, and the son contributes capital alone, the son's proportional interest in the partnership decreases as it approaches the point where it derives solely from the value of his capital investment.

53. The son is not technically a limited partner unless there is compliance with the requirements of the relevant state statute. BALLANTINE, CORPORATIONS § 3 (1946).

In a regular limited partnership, arms-length business dealing ensures that the limited partner gets a fair return on his investment under the partnership agreement and no more. Limited partners, therefore, are generally treated for tax purposes as ordinary partners. 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 35.07 (1949). Arms length arrangements, however, do not exist in tax-induced family partnerships and donor-partners are likely to credit their sons with more than the son's legitimate share of income.

54. The son in a typical family partnership case takes an insignificant, if any, part the management of the business. Furthermore, he usually has no capital to risk beyond the amount given to him for reinvestment in the business. Some courts have questioned whether the legal incapacity of a minor child prevents him from becoming a partner. See Daniel J. Fry, 4 T.C. 1045 (1945).

55. See *e.g.*, Lawrence Oliver v. Commissioner, 4 T.C. 634 (1945). There business income was attributable, in a community property state, half to services and half to capital. The Tax Court held that the portion to be attributed to capital should amount at least to the usual interest on a long term, well secured investment, in this case, a 7% return.

intended that reasonable compensation for services be credited to *partners*.⁵⁶ The statute, however, requires that allowance be made only for services rendered by the *donor*, and that the allocation to the donated capital must not be proportionately greater than that attributable to the donor's capital.⁵⁷ So drafted, the statute may allow many partnerships to avoid completely the new allocation provisions. Existing husband-wife partnerships have the best chance. Before the split-income provision of the 1948 Revenue Act, numerous husband-wife partnerships were formed to split income previously taxed to the husband.⁵⁸ After 1948, there was no tax incentive for new husband-wife partnerships. But neither was there any reason to change existing partnerships. Undoubtedly many are left. Under the 1951 law, the partner-wife can now give her share to her children, and they will be recognized as partners. Since the husband is not the donor, and the donor-wife is no longer a partner, the new law imposes no restrictions on income distribution to donees. The husband and wife can already split their income; when a child is substituted for the wife as a partner, the family makes further tax savings since it then can split income three ways. The Commissioner will doubtless ask courts to look back through the original husband-wife partnership and treat the husband as the donor. But even if the inquiry is carried this far, in cases where the wife originally invested her own capital the husband was never a donor and no restrictions on the income allocation under the new amendment would be applicable.

Change from Family Corporation to Partnership

Before 1951, family corporations were often formed because of the difficulty of obtaining tax recognition for partnerships.⁵⁹ In many cases, the Commissioner succeeded in fixing officer's salaries at a low figure, and taxing the balance of the income as corporate profits.⁶⁰ Under the new law, many of these corporations may achieve tax savings by transforming into partnerships. The court may decline to look back far enough through the corporate period to find a donor; in these cases, the family partnership will not be subject to any allocation restrictions under the new act. Even if the enterprise is considered a gift partnership, the low salary previously determined by the Commissioner may be controlling for the partnership. An important additional incentive for making such a change is the opportunity to avoid high corporate taxes and the recently renewed excess profits tax.⁶¹

56. H. R. REP. NO. 586, 82d Cong., 1st Sess. 34 (1951).

57. INT. REV. CODE § 191.

58. See note 4 *supra*.

59. See Alexandre, *The Corporate Counterpart of The Family Partnership*, 2 TAX L. REV. 493 (1947) and Mannheimer, *Income Tax Status of Gifts of Family Corporation Stock*, 25 TAXES 604 (1947).

60. See note 38 *supra*.

61. See INT. REV. CODE §§ 13,15,430-72. The excess profits tax was renewed in 1950.

De Facto Partnerships

The new law gives the Commissioner an additional weapon when a valid gift is proved. Before 191, where following an intra-family transfer no formal partnership was attempted, the Commissioner could only argue that the gift itself was invalid.⁶² Now, it is to his advantage to argue that a *de facto* partnership exists. Two recent cases⁶³ reveal attempts to avoid partnership tax problems by making a gift of income-producing property to a family member without any attempt to form a partnership. In one,⁶⁴ a sheep rancher gave each of his children part of his flock. The father continued to manage the flock and the income was distributed between the father and children. There was a separate bank account and separate legal title but otherwise things were the same as if the gift had not been made. The court upheld the gift and the split in income, stating that since no partnership existed, the decision must rest on whether there was a valid gift.⁶⁵ Since the case arose before the 1951 amendment, the Commissioner of course did not argue the existence of a *de facto* partnership, because at that time no allocation would have been permitted.⁶⁶ But under the new law, even if such a gift is held valid, the *de facto* partnership argument may allow the Commissioner to reallocate income under 191.

RETROACTIVE EFFECTS OF THE NEW AMENDMENT

Congress limited applicability of the new statute to taxable years beginning after December 31, 1950, and stated specifically that no inferences were to be drawn from the statute with respect to taxable years before 1951.⁶⁷ Since partnership cases in the courts during the next several years will involve taxable periods before 1951,⁶⁸ the date limitation of the new statute means

62. *Early v. Atkinson*, 175 F.2d 118 (4th Cir. 1949); *Henson v. Commissioner*, 174 F.2d 846 (5th Cir. 1949); *Coffey v. Commissioner*, 141 F.2d 204 (5th Cir. 1944).

63. *Alexander v. Commissioner*, 190 F.2d 753 (5th Cir. 1951); *Visintainer v. Commissioner*, 187 F.2d 519 (10th Cir.), *cert. denied*, 342 U.S. 858 (1951).

64. *Visintainer v. Commissioner*, *supra*, note 63.

65. "This transaction was not in the form or color of a family partnership or of an assignment of undivided interests in the sheep. It was in the form of gifts to the children. The taxpayer urges that it constituted gifts, and it must stand or fall as bona fide gifts rather than a family partnership or assignments of undivided interests in property." *Id.* at 522.

66. See note 36 *supra*.

67. H. R. REP. No. 586, 82d Cong., 1st Sess. 34 (1951). Pub. Law No. 183, 82d Cong., 1st Sess. § 340(c) (Oct. 20, 1951). The dispute over retroactivity was the only contested issue between House and Senate on the family partnership amendment. The Senate, following its 1950 proposal, wanted to make the legislation retroactive for taxable years back to 1938. SEN. REP. No. 2375, 81st Cong., 2d Sess. 63 (1950); SEN. REP. No. 781, 82d Cong., 1st Sess. 40-1 (1951).

68. The time-consuming process of auditing tax returns, charging deficiency assessments and, when disputes arise, appealing them to the Tax Court means that cases involving 1951 and later tax years will not be decided for several years. See 6 MERTENS,

that hundreds of cases will continue to be governed by the uncertain *Culbertson* test. Congress' determination to uphold all family partnerships if there is a valid gift of a capital interest might provide a standard for future judicial decisions even on pre-1951 cases. But the use of this standard, absent the statutory authority to reallocate partnership income, would simply be a bonanza for taxpayers. The Courts of Appeals have heretofore overruled any attempts of the Tax Court to alter income distribution under valid partnership agreements.⁶⁹ If they now recognize partnerships that would have failed before, but refuse to reallocate income for years before 1951, many taxpayers will gain all the benefits of the new legislation without any of its restrictions.⁷⁰

The Senate Finance Committee felt that judicial confusion would be better resolved if the amendment could be applied to any open taxable years since December 31, 1938 at the option of members of a partnership in a tax dispute.⁷¹ Congress, however, rejected the Senate Committee's proposal, perhaps feeling it inequitable to admit some cases under the new statute where many others, covering the same taxable years, had already been decided against the taxpayer under the old law. But the Senate suggestion would have cleared the air of *Tower* and *Culbertson* for the future, and would have been the wiser choice.

The time-reference of the new law raises another problem: will long-standing family partnerships originally created by gift, valid under the old rules, be required to submit to income reallocation for taxable years beginning in 1951? This problem will not be widespread because the distribution of income under a partnership agreement was one of the criteria previously used to determine the validity of family partnerships.⁷² No partnership which distributed income inequitably would have been upheld under the old law. But for older partnerships the fixed income of the donor, though reasonable when

LAW OF FEDERAL INCOME TAXATION §§ 35.02 *et seq.* (1949) for an indication of the time lag between the taxable year in dispute and the year when the issue is decided in the courts. Crowded calendars in the Tax Court and appellate courts will add to the delay.

69. See note 36 *supra*.

70. It is possible, however, that future decisions might have allowed reallocation even without § 191. The *Hartz*, *Canfield* and *Woolsey* cases denied reallocation on their particular facts without expressing blanket disapproval. See note 36 *supra*. Henceforth, in partnership disputes involving taxable years before the new law applies, courts may begin independently to reallocate income without regard to § 191.

71. SEN. REP. No. 781, 82d Cong., 1st Sess. 40-1 (1951): "Such an election [by a member of the partnership] will be valid only if any other members of the partnership whose taxable income would be increased consent to the assessment and collection of such deficiency, or if the taxpayer who would be entitled to a refund or reduction of his tax liability consents to the reduction of such refund or tax decrease by the amount of the related taxpayer's additional tax."

72. See *Woolsey v. Commissioner*, *Canfield v. Commissioner* and *Hartz v. Commissioner*, cited at note 36, *supra*.

the agreement was made, may not be reasonable at current values.⁷³ One solution is to exempt from income reallocation partnerships where reasonable compensation was originally made for the services of the donor. But since such partnerships would thereby be able to distribute part of the income from services to holders of capital interests, the Commissioner will not accept this answer without a struggle. More likely, old partnerships will be subject to the reallocation provisions for income earned after 1950. If this is allowed, the Commissioner may well attack any partnership in any year when he can prove that the donor's salary, once reasonable, is now too low. Lest an escalator wage scale be introduced to further complicate the family partnership problem, a judicial stand to stop harrassment by the Commissioner may be necessary.

CONCLUSION

Section 191 is an example of shabby legislative draftsmanship. Enacted to cope with a complex problem, it offers illusory solutions, poses new problems of its own, and fails to close all the family partnership loopholes. Congress' restrictions on the distribution of income once a partnership is recognized reflect either an ignorance or disregard of the economic theory which credits part of profits to the going concern. Congress again failed to accept the partnership, for profit-calculating purposes, as an economic entity as real as a corporation. And as long as the economic fact that the partnership is an entity is disregarded, confusion and contradiction are likely legislative results.⁷⁴ Particularly in the area of family partnerships, where the donee often contributes nothing of his own to the enterprise, present law fails to tax income to the one who earns it. Distributing to the donee part of the business profits earned largely by the services of the donor is contradictory to the declared intent of Congress. The 1951 statute, guaranteeing partnership recognition if there is a valid gift, provides a new opportunity for taxpayer-partners to set up trusts for their children, make the trust a partner and enjoy reduced taxes as a result. Finally, the time reference of the new amendment keeps the *Culbertson* test alive for any partnership litigation involving taxable years prior to 1951.

Apart from faulty draftsmanship, most of the problems under 191 are symptoms rather than results. They spring from the dichotomy between the economic fact of the family as an income-producing unit and the legislative policy which aims at taxing each individual member.⁷⁵ Careful judicial treatment of

73. Fixed salaries, once considered reasonable, might be attacked as "unreasonable" when wage levels rise with the increasing cost of living.

74. See Brookes, *The Strange Nature of the Partnership Under the Income Tax Law*, 5 TAX L. REV. 35, 56 (1949), and LITTLE, *FEDERAL INCOME TAXATION OF PARTNERSHIPS*, 1-18 (1952).

75. Ryan, *Federal Tax Treatment of the Family*, 32 MARQ. L. REV. 244 (1949). See also the statement of the Treasury Department on "The Tax Treatment of Family Income" reported in *Hearings Before House Committee on Ways and Means on Revenue Revisions, 1947*, 80th Cong., 1st Sess. 846-74 (1947).

the new partnership amendment may help effect its purpose. But 191 will afford little additional support for the "tax the husband" position of *Lucas v. Earl*. The *Lucas* philosophy, fully developed in the *Clifford-Horst* line of cases in opposition to intra-family transfers,⁷⁶ was partially overruled by the husband-wife split income provisions of 1948. Since in practice it will be hard to administer and enforce the reasonable compensation requirements, Section 191 may actually corrode the *Lucas* philosophy further. Ultimately, a solution to the problems of intra-family transfers may come only when the family, rather than the individual, is recognized as the basic unit for income taxation.

76. See the opinion of Mr. Justice Murphy in *Commissioner v. Sunnen*, 333 U.S. 591, 605 *et seq.* (1948).