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## THE NEXT INNING OF FAMILY PARTNERSHIPS

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Congress has just finished pinch hitting in the long-lasting family partnership feud.<sup>1</sup> Has it "sewed up" the game, has it struck out, or has it evened the score so that it is touch and go in the contest between taxpayers and tax collectors? An answer must be prefaced by the admission that the analogy creates difficulty since there will be disagreement as to whether Congress was batting for the taxpayers or for the tax collectors.

Too much history on the taxation of family partnerships is not required, since so much has already been written up to the *Culbertson*<sup>2</sup> chapter in 1949.<sup>3</sup> The unusual determination of that case is exemplified by an opinion of the Court by Chief Justice Vinson, concurring opinions by Justice Burton and by Justice Frankfurter, and separate notations as to the views of Justices Black and Rutledge and of Justice Jackson. It can be said that this last pronouncement of the Supreme Court established the very general rule, for whatever it may be worth, that a family partnership is no different, taxwise, from any other partnership so long as the parties "really and truly intended to,"<sup>4</sup> and actually did, form the partnership. Thus, the way appeared to be open for taxpayers to reduce the taxes payable to the collector by taking relatives or others into partnership.

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

2. *Comm'r v. Culbertson*, 337 U.S. 733 (1949).

3. See, e.g., Bruton, *Family Partnerships and the Income Tax—The Culbertson Chapter*, 98 U. OF PA. L. REV. 143 (1949).

4. The Court, 337 U.S. 733, 741-743, in stressing this subjective test, relied on language quoted from *Comm'r v. Tower*, 327 U.S. 280, 287 (1946).

The reduction in taxes can be visualized by the following comparative approximate figures for 1951 as to *A*, who has two daughters, *B* and *C*, and whose only asset is a business which produces a net income of \$150,000:

<i>Sole Proprietorship</i>		<i>Family Partnership</i>	
Tax on <i>A</i> for		Tax on <i>A</i> for \$50,000	\$25,000
\$150,000	\$110,000	Tax on <i>B</i> for \$50,000	25,000
		Tax on <i>C</i> for \$50,000	25,000
	\$110,000	Total Tax	\$75,000

Thus, if they really and truly formed a partnership, the taxes payable by the family would be \$75,000 instead of \$110,000. Of course, if *A* is married, he already has the benefit of splitting the income between himself and his wife, so that in such a case, the maximum family tax saving would result by giving *B* and *C* smaller interests, but the over-all saving would be less than \$35,000.

An important factor which, though obvious, must nonetheless be kept in mind, is that the saving is not to *A*. As sole proprietor, he owns the business, and his income after taxes is \$40,000. As a partner, he owns only one-third of the business, he may have some gift tax liability, and his income after taxes is \$25,000. The true saving goes to the other members of the partnership, or to the family if it is considered as a collective unit. Congress does for certain tax purposes consider the family as a unit,<sup>5</sup> but Courts should not resort to abstract economic theories to change tax patterns.<sup>6</sup>

A purported family partnership might not have been really and truly a partnership either before or after *Culberston*, for any one of the following reasons:

(1) the partnership might have been a sham, because the parties agreed that the paper transactions were to save taxes and not to be otherwise effective;<sup>7</sup>

5. See, e.g., INT. REV. CODE §§ 24(b)1(A), 503(a)2.

6. But see the caustic (yet humorous and learned) opinion of Chief Judge Hutcheson in *Batman v. Comm'r*, 189 F.2d 107 (5th Cir. 1951). He speaks of the "over thrifty and under candid" arrangement for "familial sharing" whereby a taxpayer would like to "have his cake and eat it too," and by the magic talisman of the word "partnership" attempts to engage in "shoring up and expanding the family fortunes at the expense of the tax collector."

7. "The question always is whether the transaction under scrutiny is in fact what it appears to be in form; a marriage may be a joke; a contract may be intended only to deceive others; an agreement may have a collateral defeasance." L. Hand, J., in *Chisholm v. Comm'r*, 79 F.2d 14, 15 (2d Cir. 1935).

(2) it might have been, in effect, merely a contract to assign future income, because the business was a personal service business or because the only interest of a partner was in future income;<sup>8</sup> or

(3) it might have been so unusual in the terms of the agreement<sup>9</sup> or in the actual operation of the partnership, as to permit the former owner to retain practically all the normal incidents of ownership.<sup>10</sup>

A great source of confusion had been the failure on the part of accountants, tax collectors, lawyers and judges to recognize the difference between matters of evidence and rules of law. Failure of an alleged partner to provide personal services or to provide capital originating outside the business might have been of some evidentiary value in attacking the reality of the partnership but as the *Culbertson* case pointed out no rule of law ever existed which required either one of these factors for the formation of a partnership.

#### POST-CULBERTSON ERA

The post-*Culbertson* era produced in its wake a tremendous amount of litigation. In fact, in the two year period, thirty-seven family partnership cases were decided by United States Courts of Appeal, and hundreds of such cases were before the Tax Court and District Courts. Although the cases deal primarily with questions of fact,<sup>11</sup> it might be of some advantage to set up a box score to show how taxpayers have fared in the appellate courts since *Culbertson*. Extreme caution must always be exercised in attempting to make any deductions from bare statistics of results. The following is a box score of all the cases involving family partnerships which have been decided by Courts of Appeal since *Culbertson*:

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8. The Supreme Court had already held such alleged partnerships ineffective, *Burnet v. Leininger*, 285 U.S. 136 (1932); *cf.* *Lucas v. Earl*, 281 U.S. 111 (1930). A logical extension exists under the rule of *Comm'r v. Sunnen*, 333 U.S. 591 (1948) where the former owner retains control over the source of income or has a right of recapture. *Stanton v. Comm'r*, 189 F.2d 297 (7th Cir. 1951). This rule, however, should not preclude a joint venture interest in a partnership interest. In *United States v. Atkins*, 191 F.2d 146, *reversing*, 189 F.2d 414 (5th Cir. 1951), the Court reversed itself on a rehearing of this issue.

9. Normal restrictions on all partners or management powers in one partner will not defeat the partnership. This is evident from the limited partnership cases. *Lamb v. Smith*, 183 F.2d 938 (3d Cir. 1949); *Greenberger v. Comm'r*, 177 F.2d 990 (7th Cir. 1949). *But cf.* *Giffen v. Comm'r*, 190 F.2d 188 (9th Cir. 1951) where the Court agreed that the limited partners had been given a bare expectancy.

10. In *Morrison v. Comm'r*, 177 F.2d 351, 352 (2d Cir. 1949) a per curiam opinion affirmed the Tax Court which had found that the evidence "gives us a picture of a man who was not a partner but in reality a sole proprietor."

11. It has aptly been pointed out that it serves no real purpose to ferret out a part of the facts of analogous cases, since no one fact can be decisive. *Eisenberg v. Comm'r*, 161 F.2d 506, 510 (3d Cir. 1947).

*Family Partnership Cases in Courts of Appeal*

Fact Finding Body	Affirmed for		Reversed for	
	Taxpayer	Collector	Taxpayer	Collector
Tax Court	0	13 <sup>12</sup>	11 <sup>13</sup>	0
Jury	2 <sup>14</sup>	2 <sup>15</sup>	0	0
Judge	7 <sup>16</sup>	1 <sup>17</sup>	1 <sup>18</sup>	0
Total	9	16	12	0

Thus, of the cases appealed to Courts of Appeal, the score stands 21 to 16 in favor of the taxpayers, and all twelve reversals were in favor of the taxpayers.

What generalizations can fairly be drawn from these figures? Significantly, it is to be noted that there were twenty-four appeals from Tax Court decisions in favor of the government, eleven of which resulted in reversals in favor of the taxpayers. The fact that there is not a single appeal by the collector from a Tax Court decision in favor of a taxpayer is a sign that the collector was apparently satisfied with the slant of the Tax Court in these cases.<sup>19</sup> The fact that all four jury verdicts in these cases were upheld is some evidence that the Courts

12. *Anderson v. Comm'r*, 185 F.2d 1021 (2d Cir. 1951); *Barrett v. Comm'r*, 185 F.2d 150 (1st Cir. 1950); *Batman v. Comm'r*, 189 F.2d 107 (5th Cir. 1951); *Buckley v. Comm'r*, 180 F.2d 749 (3d Cir. 1950); *Collamer v. Comm'r*, 185 F.2d 146 (4th Cir. 1950); *Feldman v. Comm'r*, 186 F.2d 87 (4th Cir. 1950); *Giffen v. Comm'r*, 190 F.2d 188 (9th Cir. 1951); *Mendelsohn v. Comm'r*, 186 F.2d 306 (3d Cir. 1951); *Morrison v. Comm'r*, 177 F.2d 351 (2d Cir. 1949); *Nelsen v. Comm'r*, 177 F.2d 203 (6th Cir. 1949); *Nelson v. Comm'r*, 184 F.2d 649 (8th Cir. 1950); *Stanton v. Comm'r*, 189 F.2d 297 (7th Cir. 1951); *Wester v. Comm'r*, 189 F.2d 856 (5th Cir. 1951).

13. *Ardolina v. Comm'r*, 186 F.2d 176 (3d Cir. 1951); *Britt Est. v. Comm'r*, 4 P-H 1951 FED. TAX SERV. ¶72,539 (5th Cir. 1951); *Cobb v. Comm'r*, 185 F.2d 255 (6th Cir. 1950); *Denning & Co. v. Comm'r*, 180 F.2d 288 (10th Cir. 1950); *Eckhard v. Comm'r*, 182 F.2d 547 (10th Cir. 1950); *Greenberger v. Comm'r*, 177 F.2d 990 (7th Cir. 1949); *Johns v. Comm'r*, 180 F.2d 469 (5th Cir. 1950); *Maiatico v. Comm'r*, 183 F.2d 836 (D.C. Cir. 1950); *Miller v. Comm'r*, 183 F.2d 246 (6th Cir. 1950); *Wenig v. Comm'r*, 177 F.2d 62 (D.C. Cir. 1949); *Yost v. Comm'r*, 4 P-H 1951 FED. TAX SERV. ¶72,482 (5th Cir. 1951).

14. *Lamb v. Smith*, 183 F.2d 938 (3d Cir. 1950); *Thompson v. Riggs*, 175 F.2d 81 (8th Cir. 1949).

15. *Parker v. Westover*, 186 F.2d 49 (9th Cir. 1950); *Stanback v. Robertson*, 183 F.2d 889 (4th Cir. 1950).

16. *Arnold v. Green*, 186 F.2d 18 (5th Cir. 1951); *Crossley v. Campbell*, 184 F.2d 639 (7th Cir. 1950); *Glenn v. Cooke*, 177 F.2d 201 (6th Cir. 1949); *Jones v. Baker*, 189 F.2d 842 (10th Cir. 1951); *Jones v. Trapp*, 186 F.2d 951 (10th Cir. 1950); *Rupple v. Kuhl*, 177 F.2d 823 (7th Cir. 1949); *United States v. Atkins*, 191 F.2d 146, *reversing* 189 F.2d 414 (5th Cir. 1951).

17. *Trapp v. United States*, 177 F.2d 1 (10th Cir. 1949).

18. *Ginsburg v. Arnold*, 185 F.2d 913 (5th Cir. 1950).

19. ". . . the Tax Court has proven, thus far, to be an unduly Treasury-minded forum in family-partnership controversies . . ." Landman, *Family Partnerships and the Reality Test*, 28 TAXES 551, 559 (1950).

really consider these issues as factual.<sup>20</sup> Finally, a weak inference<sup>21</sup> of the desirability to a taxpayer of a trial without a jury is to be gleaned from the fact that trial judges decided the factual issue seven times in favor of the taxpayer and twice in favor of the collector.

The most important conclusion to be drawn from these cases is the correctness of the old suggestion that there was "crying need for a further clarification of the family partnership situation under the Internal Revenue Code."<sup>22</sup> The possible variation in result, depending upon whether a taxpayer has enough money to pay the tax and sue for his refund in the District Court, as opposed to delaying payment with the hope of winning an uphill battle in the Tax Court, should be shocking to all moral sense. Manifestly, no statute or regulation is going to end all the litigation, but certainly there was the need for Congressional action.

#### THE 1951 CONGRESSIONAL ACTION

The compromise of a bitter battle in 1950 eliminated Senate sponsored action as to family partnerships, but apparently with the understanding that the House would assent to action in 1951.<sup>23</sup> Accordingly, the Revenue Bill of 1951,<sup>24</sup> introduced in the House on June 15, 1951, contained provisions affecting family partnerships. The provisions as reported by the Senate Finance Committee<sup>25</sup> were substantially similar, except that the Senate Bill was made applicable under certain conditions to all tax years after 1938 instead of after 1950.

The Revenue Bill of 1951<sup>26</sup> as finally enacted deals with family partnerships in section 340 which contains three subdivisions. Subdivision (a) adds to the definition of a partnership which appears in § 3797(a)(2) of the Internal Revenue Code, a statement that a partner shall be recognized for tax purposes "if he owns a capital interest in a partnership in which capital is a material income-producing factor,

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20. "The learned trial judge wisely submitted interrogatories to the jury which pinpointed the ultimate issues of the case. Finally, those issues of fact being resolved by the jury, they are beyond our reach, for it is well-settled, indeed it would be a work of supererogation now to attempt to prove, that the historical function of the jury cannot be the subject of interference when the evidence permits reasonable minds to disagree." *Lamb v. Smith*, 183 F.2d 938, 942 (3d Cir. 1950). The legislative repeal of the *Dobson* rule [*Dobson v. Comm'r*, 320 U.S. 489 (1943)] means that Tax Court decisions are now subject to the same review as District Court decisions in civil actions tried without a jury. INT. REV. CODE § 1141(a).

21. The inference is weak because it disregards the results in all the trials which have never been appealed.

22. *Bruton*, *supra* note 3, at 160.

23. 2 U.S. Code Cong. Serv. 3264 (1950).

24. H.R. 4473, 82nd Cong., 1st Sess. § 313 (1951).

25. *Ibid.*, as reported in the Senate on September 18, 1951, § 339.

26. See note 1 *supra*.

whether or not such interest was derived by purchase or gift." Subdivision (b) adds to the Code a new section to permit, for tax purposes, the reallocation by the collector of partnership income in disregard of the partnership agreement where (1) a partnership interest is created by gift or sale to a member of the family<sup>27</sup> and (2) the transferor is not allowed by the partnership arrangement reasonable compensation for his personal services or a proportionate return for his share of capital, with the qualification that there should be no reallocation because of absence due to military service. Subsection (c) makes the provisions effective as to taxable years after December 31, 1950, and contains the *caveat* that no inferences are to be drawn from the fact that the provisions are not expressly made applicable to previous taxable years.

This general statement of the statutory changes makes it rather manifest that family partnership problems are not ended. There is the matter of determining whether capital is a material income-producing factor, and the effect to be given a negative determination. Then there are the problems as to when there should be reallocations of income, and the practical bases on which they are to be made. Finally, there are the questions relating to the retrospective effect of the legislation.

### 1. *Capital as a Material Income-Producing Factor*

The declared purpose of the new provisions to clarify the recognition of family partnerships for tax purposes is based upon the premise that the real ownership of an interest in a partnership should not differ taxwise from the ownership of any other asset.<sup>28</sup> If *A* owns an office building, there appears to be no reason for refusing to recognize the transaction taxwise whether: (1) *A* conveys one-half of the fee to *B*, his daughter; (2) *A* forms a corporation with that asset and turns over one-half of the shares to *B*; or (3) *A* takes *B* into partnership by giving her a one-half interest in the office building as a partnership asset. The concept that a special business purpose must be the motive for the creation of a partnership interest, should now be eliminated completely.<sup>29</sup>

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27. "Family" is defined in this new section to include only "spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons." Significantly, collateral relatives are thereby excluded from the effect of this new section.

28. H.R. REP. No. 586, 82nd Cong., 1st Sess. 32 (1951). An actual transfer of legal ownership of business assets to family members presents essentially the same problem as the formation of a family partnership. *Visintainer v. Comm'r*, 187 F.2d 519 (10th Cir. 1951), *cert. denied*, 20 U.S.L. WEEK 3103 (Oct. 23, 1951).

29. SEN. REP. No. 781, 82nd Cong., 1st Sess. 39 (1951); *cf.* *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950), where it is held that business motive may be relevant in determining whether a transfer in liquidation followed by a sale made by the shareholders is real or a sham, but if the transaction is real the lack of business motive is not significant.

Under the new legislation, and assuming that the transaction is not a sham, a partner's right to share in profits will have to be recognized if he owns some of the capital which is a material income-producing factor. The requirement of a capital interest, as well as profit sharing, is in accordance with traditional concepts. The Uniform Partnership Act, for instance, provides in section 7 that profit sharing is *prima facie* evidence of a partnership. Here again, matters of evidence are not to be confused with a legal rule. Profit sharing alone does not create a partnership. "The indispensable requisites of a partnership are co-ownership of a business and the sharing of its profits."<sup>30</sup> Justice Holmes, in a leading case involving the tort liability of associates in business activity, has pointed out the danger of basing the result on whether the association is to be given the tag of "partnership."<sup>31</sup> The objection to the disregard of the tag in a tax case is that Congress has seen fit to use that tag and hence its use as the litmus paper to test tax results is justifiable.

The new legislation provides no test to determine whether capital is a material income-producing factor. The historical use of the phrase makes it clear that even in a personal service business, capital can still be a material income-producing factor.<sup>32</sup> Determinations as to whether capital is a material income-producing factor will turn on evidence as to the total amount of capital, the use to which the capital is put, the nature of the business, the type of assets and the relationship of income to proprietorship services. No specific rule can control.<sup>33</sup> A backhanded, yet practical, approach in the light of the purpose of the determination, would be testimony as to whether the death of one or more of the partners would tend substantially to end the income of the partnership.

There is no express statement in the new legislation to cover the situation where capital is not a material income-producing factor.<sup>34</sup>

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30. *Schuster v. Largman*, 308 Pa. 520, 528, 162 Atl. 305, 307 (1932).

31. *Guy v. Donald*, 203 U.S. 399, 405-6 (1906).

32. For tax years prior to January 1, 1944, the expression was used in connection with an earned income credit and the regulations expressly recognized that personal services and capital can each be material income-producing factors. U.S. TREAS. REG. 111, § 29.185-1 (1943).

33. Thus the regulations with respect to the old earned income credit provide: "No general rule can be prescribed defining the trades or businesses in which personal services and capital are material income-producing factors, but this question must be determined with respect to the facts of the individual cases." U.S. TREAS. REG. 111, § 29.25-2 (1943).

34. In *Greenberger v. Comm'r*, 177 F.2d 990, 994 (7th Cir. 1949) the Tax Court's decision in favor of the collector was reversed even though it had found that "Capital was not a material income producing factor in the operation of the business." The Court of Appeals admitted that the invested capital was small but stressed that "the parties stood ready to contribute further capital, if needed, . . . and, of course, they were personally liable for the liabilities of the partnership."

Does the provision mean that an architect, for example, cannot take his own son into partnership to carry on their profession, and have it recognized as valid by the taxing authorities? The provision is a direction as to a particular situation in which a family partnership should be recognized, and it does not purport to exclude other situations from being similarly recognized. Its primary purpose as already stated is to avoid any distinction in the recognition of a partnership based upon whether the interest is ultimately traced to an actual purchase or a gift.

A person can become a partner even though his capital account may start at zero. The employee who is taken in as a partner often starts on that basis. Title to the business assets, even though only office furniture, passes to the partnership, so that there is co-ownership. The partner who starts with no capital, nonetheless, has in this typical case an interest in capital assets as they accumulate. Thus, even though capital is not a material income-producing factor, a partnership can be valid taxwise, if supported by facts other than a gift of a capital interest.

## 2. *Reallocation of Income in Disregard of Partnership Agreement.*

The *Culbertson* case expressly left open the matter of reallocation of income as between partners. "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."<sup>35</sup> The Eighth Circuit in the *Hartz* case,<sup>36</sup> following the lead of the Sixth Circuit in the *Canfield*<sup>37</sup> and *Woosley*<sup>38</sup> cases, had held that if the family partnership is valid, the tax collector cannot, for tax purposes, rewrite the provisions of the partnership agreement. On the same day the *Culbertson* case was decided, the Supreme Court denied certiorari in the *Hartz* case in which the government had asked for a review of this issue of reallocation.<sup>39</sup> No case since then has decided this issue in favor of the collector, but there is not much doubt that many cases involving the validity of the partnership were compromised on the basis of a reallocation of income.

The new legislation now swings the pendulum the other way, so that reallocation of income under certain circumstances is provided for under a new section 191 of the Code. It means that after establishing the validity of the partnership, the taxpayer must also satisfy the

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35. 337 U.S. 733, 748 (1949).

36. *Hartz v. Comm'r*, 170 F.2d 313 (8th Cir. 1948).

37. *Canfield v. Comm'r*, 168 F.2d 907 (6th Cir. 1948).

38. *Woosley v. Comm'r*, 168 F.2d 330 (6th Cir. 1948).

39. 337 U.S. 959 (1949).

tax collector with respect to the distribution of profits. The effectiveness of the new section will depend, to a great extent, upon the manner in which it is administered. An enlightened approach, from the standpoint of the real evil which it is designed to meet, will probably limit its use to cases where the over-all financial relationship of the parties is clearly unreasonable.

Specifically, the new section provides that for tax purposes reallocation of income, contrary to the terms of a valid family partnership agreement, is not to take place unless the former owner is not receiving reasonable compensation for his services or a proportionate return for his capital. An illustration of a situation where difficulty can arise is a family partnership agreement between father and son, which provides for a sharing of the profits of the father's former business with no provision for compensation for services. A too literal application of the section might lead to the conclusion that the father, the donor, must be taxed upon a reasonable compensation for himself plus his share of the profits, without regard to any compensation for the donee son.<sup>40</sup> The section states expressly that distributive shares are not to be diminished by absence due to military service. *A fortiori*, if there is no absence of services, but actual services by the donee partner, those services should be considered before making any reallocation.

Another approach to effect this sensible result is to keep in mind that compensation can be paid or provided for in the form of profits. Thus, if the father and son perform services of equal value, no specific provision with respect to compensation would mean that they are receiving their compensation in the form of profits. Take the case where the capital interests are in the ratio of  $\frac{3}{4}$  and  $\frac{1}{4}$ , and profits are distributable in the same proportion. If the father's services as compared to the son's are in that same ratio, the father would be receiving reasonable compensation in his share of the profits. If, however, reasonable compensation to the father would be substantially in excess of a ratio of  $\frac{3}{4}$  to  $\frac{1}{4}$ , then it would be appropriate to consider that the father is not receiving reasonable compensation to the extent of such excess. Thus, in this illustration, if the father's services were worth \$40,000, and the son's \$4,000, it could be said that the father was getting some compensation in his portion of the profits. Accordingly, \$44,000 of the profits can be said to be the compensation of the father and the son, but since it was shared in the ratio of  $\frac{3}{4}$  to

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40. The legislative history shows that the Congressional intent was otherwise. "In such cases a reasonable allowance will be made for the services rendered by the partners, and the balance of the income will be allocated according to the amount of capital which the several partners have invested." H.R. REP. No. 586, 82d Cong., 1st Sess. 34 (1951).

$\frac{1}{4}$ , or \$33,000 and \$11,000, there should be a reallocation by adding to the father's distributive share the sum of \$7,000.

This administrative problem is only one of the complications brought on by this new feature of the law. There is, of course, the very serious matter of determining what amount is a reasonable compensation under all the facts of the case. Heretofore, the collector has worried about reasonable compensation by attempting to cut it down in the case of officers of close corporations. Yet, in this instance the tax collector's position will be the reverse, in that he will assert that the amount received by the former owner is not enough to constitute reasonable compensation. Much can be written on this subject alone; but it is again submitted that the situation calls for good administration, so that there will be a demand for reallocation only in the case where the partnership provisions, as a whole, are clearly unreasonable in disregarding the value of the services of the original owner.

The reallocation of profits is also directed when the agreement gives a greater proportionate return of profits on capital to a donee than to a donor. The father who gives his son a  $\frac{1}{10}$  interest in the partnership, and yet tries to give him  $\frac{1}{3}$  of the profits because of the son's capital interest will have to add the difference between  $\frac{1}{10}$  and  $\frac{1}{3}$  of the profits to his own taxable income. Of course, if services are performed without compensation provided therefor, then the same problem just referred to exists in determining to what extent the partner is receiving a share of profits in lieu of compensation for services. In such instances only the sum in excess of compensation for services is to be considered as the share attributable to capital. Much difficulty will be avoided in the future if family partnership agreements make provision for the payment of compensation for services of partners. Such compensation can be either a fixed sum or a percentage of the profits, or a combination of the two.

Still one other problem is created by the new section. It purportedly deals only with partnership interests created by gift or by purchase from a family member. Many partnerships are created merely by a contract which specifically calls for no purchase or gift of an interest. The language used in section 191 is not too satisfactory insofar as it deals with a partnership which is newly formed. Astute counsel may well argue that when a sole proprietor forms a partnership with a member of the family, there is rarely a partnership interest created by gift, and never a purchase of a partnership interest. Thus, it will be contended that when a partnership is formed by the putting up of capital or services or both, the relationship ensues or is created

because of the partnership agreement and not because of any gift or purchase. Taxation, however, is a practical matter, and courts will not permit the niceties of legal conveyancing to affect the result. It would appear, therefore, that the new section will be applied to family partnerships whether new interests in an existing partnership are created or the partnership is newly created, and whether or not it is contended that the case presents no element of gift or purchase of a partnership interest.

### 3. *The Retrospective Effect of the Legislation*

The family partnership changes in the Revenue Act of 1951 are stated to be applicable with respect to taxable years beginning after December 31, 1950. As to prior taxable years, there is an express statement that no inference is to be drawn from the enactment or from the date set for it to go into effect. Such a super-cautious hands-off policy is in direct contrast to the defeated Senate suggestion that the legislation be made retroactive under certain circumstances to taxable years after 1938. The suggestion was refused, notwithstanding the recognition that "the settlement of many cases in the field is being held up by" the tax collector.<sup>41</sup> A Senate suggestion was accepted, however, to make clear that when partners and the partnership had different taxable years, the Act would be effective as to 1951 taxable years of the partners, only if the distributive share of no partner would be includible in a 1950 return.

The first part of the legislation deals only with the question of the recognition of family partnerships, and, as pointed out above, is in effect declaratory of the rule adopted by most of the courts. It would seem, therefore, that despite the unusual provisions as to effective date, any old disputes, presently existing as to the validity of family partnerships, will be settled in accord with the rule declared in the new legislation.

A much more serious problem is presented as to reallocation of income, as provided for by the new section 191. Although as stated earlier, the Supreme Court has never expressly acted on the issue, it does appear that the new provision effects a complete change. Courts, therefore, will in all likelihood refuse to uphold any reallocation of partnership income in disregard of the partnership agreement as to taxable years prior to January 1, 1951.

The reallocation provided for in the new section appears to be applicable, under the stated circumstances, to any family partnership.

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41. H.R. REP. No. 586, 82d Cong., 1st Sess. 33 (1951).

With that assumption, an issue as to taxes for 1951 or for later years will exist whether the partnership was formed in 1951 or earlier. This may open hosts of new problems for existing family partnerships of long standing. The original owner who is still active in the business may find his taxes substantially increased because a decade ago he agreed to run the partnership without any specific compensation. Then, again, it could mean that each year the whole situation must be re-examined to see whether, under the facts of the current year, the compensation allowed to the owner is reasonable.

One way of avoiding a good number of these issues is to take the position that there is to be reallocation only if at the time the family partnership was created, adequate provision was not made for the services of the donor. If the agreement, under all the circumstances existing at the time it was made, contained provisions to give the donor reasonable compensation, it is not material that future developments have brought about a situation which makes that compensation very low. Obviously, an annual compensation of \$5,000 for the former owner as fixed in 1937 by the partnership agreement might not be reasonable compensation under 1951 standards. That, however, does not appear to be the kind of situation in which Congress intended to impose an additional tax on the original proprietor.

Another method of approach which might be urged upon the courts is that section 191 must be construed prospectively except insofar as it is expressly made retroactive. Accordingly, it will be urged that although it is made applicable to taxable years beginning after December 31, 1950, it cannot be applied to partnership arrangements in existence prior to that date. This argument, however, overlooks the point that the legislation is a tax measure and not a regulatory measure. When it refers to income of partnerships created by gift, it means prospective income only, except to the extent that it is expressly made retroactive, but it does not mean that the reference is only to prospective or newly created partnerships. The fair assumption, therefore, is that section 191 will be applied even to old family partnerships.

#### CONCLUSION

Upon final analysis it would appear that Congress has done a satisfactory job in trying to cope with this serious problem which has been confronting the courts. Congress has made it sufficiently clear that family partnerships are not to be disregarded for tax purposes merely because a member owns his partnership interest as the result

of a direct or indirect gift from the former owner of the interest or of the business. There may be criticism from an economic or from a legislative drafting standpoint, as to the provision for the reallocation of income in disregard of the partnership agreement; but, to a substantial degree, any real objection can be cured by sound administrative policy.