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## Commissioner v. Culbertson - An Analysis of the Family Partnership Problem

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that in requiring operators to keep within the bounds of *lawful use* and *due care*, the utility of their acts is not allowed to "completely dominate the situation," but on the contrary, a uniform and stable test for redressable injury is preserved.

*Eldon R. Vaughan.*

### COMMISSIONER V. CULBERTSON—AN ANALYSIS OF THE FAMILY PARTNERSHIP PROBLEM

ON a ranch near Dalhart, Texas, some ten years ago, R. S. Coon forged the first link in a chain of circumstances which ultimately led to a reanalysis by the Supreme Court of the United State of the troublesome problem of taxation of family partnerships.

Almost from the moment of the Supreme Court's decision in the earlier leading family partnership cases of *Tower*<sup>1</sup> and *Lusthaus*,<sup>2</sup> there has been a great deal of discussion as to their intended meaning. The *Tower* and *Lusthaus* cases involved the familiar type situation in which a husband, finding himself in a high surtax bracket, made a gift to his wife of an interest in his business. In each case, the husband and wife thereafter formed a partnership, the wife contributing the capital which her husband had given her, but not contributing either vital services or capital originating with her, and not taking part in the management or control of the business. In each case the Supreme Court looked through the form of the transactions, viewed the substance, ascertained that the husband had, directly or indirectly, given his wife that which she contributed to the business for the purpose of reducing his income taxes, and ruled that the total income from the business was taxable to the husband.

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<sup>1</sup> *Commissioner v. Tower*, 327 U. S. 280 (1946).

<sup>2</sup> *Lusthaus v. Commissioner*, 327 U. S. 293 (1946).

With those decisions already of record, the case of *Commissioner of Internal Revenue v. W. O. Culbertson, Sr.*,<sup>3</sup> came, by writ of certiorari, before the Court. The taxpayer had been, up until October, 1939, in the cattle business, operating as a partner with R. S. Coon. Coon, 79 years of age and in ill health, wanted to terminate the partnership, and agreed to sell out to Culbertson if the latter would sell an undivided one-half interest in the partnership interests to his, Culbertson's, four sons. Coon wanted Culbertson to take the sons into the business because of his desire to see their registered hereford strain maintained and because of Culbertson's advanced age. Culbertson bought Coon's interest for \$99,440.00, subject to the foregoing qualification and two days later sold an undivided one-half interest to the four boys. The boys gave their father a note for \$49,270.00, bearing 4% interest, and due to mature one year from date as payment for their interest. That note was later replaced by one for \$57,674 to cover the acquisition of additional property owned by the old partnership. The partnership agreement was oral, but was reported in the local papers, and a bank account on which Culbertson, the four boys, and a bookkeeper could check, was opened. The oldest son was 24 years old, lived on the ranch, had been foreman under the old partnership, and received \$100.00 per month, board, and lodging for himself and his wife under the old partnership and the new, until he went to the Army. The second son, 22, finished college and went into the Army in 1940, the first year of the new partnership's operations. The two younger sons, 18 and 16 years of age, attended school during the winter and worked on the ranch during the summer. The tax years in question were 1940 and 1941. A partnership return was filed for both years, indicating a division of income approximating the capital attributed to each partner.

The Commissioner and Tax Court disallowed the division of income on the ground that a valid partnership did not exist. The

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<sup>3</sup> 337 U. S. 733 (1949).

Court of Appeals for the Fifth Circuit reversed. Upon claim being made by the Commissioner that the principles of the *Tower* and *Lusthaus* cases had been departed from in the Court of Appeals decision, the Supreme Court granted certiorari. The Court's decision, reversing and remanding, was announced on June 27, 1949.

From its decision in the *Culbertson* case, it was apparent that the Tax Court interpreted the *Tower* and *Lusthaus* opinions to mean that the correct manner in which to handle family partnership cases was to apply to the particular facts the mechanical tests of (1) contribution of original capital and (2) contribution of vital services. "Partners" who failed to meet one or both of these tests, thought the Tax Court, could not bear a part of the tax incidence in the "partnership."

The Tax Court was not alone in its opinion that the Supreme Court, particularly in the *Tower* case, had laid down a more or less rigid test for the determination of the validity of such a partnership arrangement. Other writers share that opinion, one, for example, having this to say:

"Under these decisions the rule is that a partnership among family members is not recognized for income tax purposes unless the members meet the test of actual participation in the business. This may be either through the investment of new capital or performance of services related to management and control of the business or the rendering of vital services."<sup>4</sup>

The Circuit Court reversed the Tax Court's decision in the *Culbertson* case, using as its basis the belief that the correct interpretation of the *Tower* and *Lusthaus* opinions would permit the use of the test of "future intent" on the part of the sons to become full, active partners in determining whether or not, for tax purposes, there was an actual partnership.<sup>5</sup> Applying that test, the Circuit Court held that the sons were partners.

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<sup>4</sup> Editorial Opinion, 5 P-H FED. TAX SERV., § 72,012 (1949).

<sup>5</sup> "Neither statute, common sense, nor impelling precedent requires the holding that a partner must contribute capital or render services to the partnership prior to the time that he is taken into it. These tests are equally effective whether the capital and the

The Supreme Court severely criticized the Tax Court's interpretation of the *Tower* and *Lusthaus* opinions. Mr. Chief Justice Vinson, author of the majority opinion, quickly found fault with the mechanical tests applied by the Tax Court, and stated that whether or not a particular partnership is such for federal income tax purposes is a question of present intent. The Court felt that the question was not so much one of contribution of original capital or vital services, but rather, whether or not the parties intended to join together in good faith and with a business purpose in the present conduct of the partnership enterprise. Mr. Justice Frankfurter, in a concurring opinion, said he thought the Tax Court failed to read and understand the *Tower* and *Lusthaus* opinions in their entirety. He said the Tax Court had culled phrases from the opinions in the *Tower* and *Lusthaus* cases which led to a misconception of the principles enunciated therein when read out of context.

The Court found fault, also, with the Circuit Court opinion. Mr. Chief Justice Vinson's opinion rejected the view that a future intent to provide valuable services would suffice to establish a valid partnership under income tax law. He said that such an intent could not meet the requirements of Sections 11 and 22(a) of the Internal Revenue Code that he who presently earns income through his own labor and skill and utilization of his own capital must be taxed therefor.<sup>6</sup>

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services are presently contributed and rendered or are later to be contributed or to be rendered. Moreover, a partnership is formed to act in the future and not in the past and when it is fully expected, intended, and agreed that the incoming partner will render services to the partnership, the Government should not be heard to say: 'I will not recognize you as a partner even though you in good faith entered into it. I took you into the Army to fight a war and you did not perform services for the partnership as you had agreed to do.' " *Culbertson v. Commissioner of Internal Revenue*, 168 F. (2d) 979 (1948).

<sup>6</sup> "If it is conceded that some of the partners contributed neither capital nor services to the partnership during the tax years in question, as the Court of Appeals was apparently willing to do in the present case, it can hardly be contended that they are in any way responsible for the production of income during those years. Of course, one who has been a bona fide partner does not lose that status when he is called into military or government service, and the Commissioner has not so contended. On the other hand, one hardly becomes a partner in the conventional sense merely because he might have done so had he not been called. . . . The intent to provide money, goods, labor or skill some

It was apparent throughout its opinion that the Court found both the Tax Court and the Court of Appeals decisions to be too limited in scope. Each decision had in its own way made a mechanical process of the determination of the partnership's validity. The Tax Court had considered the present contribution of capital and services to the exclusion of intent, present and future, while the Court of Appeals had ignored the important aspects of present intent, present contribution of capital, and present vital services.

It is apparent that the Supreme Court, in its opinion, attempted to lay down a broad basis upon which future triers of the facts can determine whether or not, in a given case, a valid family partnership exists which will legally disperse the incidence of taxation of the income of the particular enterprise. The Court set out, as a test to be followed by the Tax Court in its subsequent hearing of this and other cases, the collective consideration of all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income, and the purposes for which it is used, and any other facts throwing light on their true intent, and whether the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.<sup>7</sup>

In the future, if the Tax Court states in its opinions that it has taken into consideration all of the criteria recommended by the Supreme Court for the determination of the validity of these family partnership agreements, and if there be substantial evidence available to support the findings of the Tax Court, then the taxability of all family partnerships will be finally settled at the trial

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time in the future cannot meet the demands of Sections 11 and 22(a) of the Code that he who presently earns the income through his own labor and skill and the utilization of his own capital be taxed therefor. The vagaries of human experience preclude reliance upon even good faith intent as to future conduct as a basis for the present taxation of income." 337 U. S. 733, 738.

<sup>7</sup> *Id.* at 742.