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GIFT AND ESTATE TAX IMPLICATIONS OF FAMILY PARTNERSHIPS

By

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The laws of chemistry have demonstrated that the combination of two volatile substances often produces an explosion, the intensity of which far exceeds the sum total of their individual explosive properties. Similar rules of action and reaction obtain in the field of Federal taxation. For example, the status of "family partnerships" in recent years has had inherent in itself highly explosive tax consequences. Contemporaneously, the existence and valuation, for tax purposes, of "good will" has not been lacking in disruptive quality. Comes now the combination of these volatile tax problems! The impact of their union and its tax effects form the subject matter of this article.

One of the most controversial tax problems of these years has been the status of family partnerships. The desire, in many instances, to avoid the higher individual surtax brackets by redistributing business income among members of the owner's family, through the use of a family partnership, has lured many a business man—much to his present regret. The United States Supreme Court recently considered the problem and although the situation has not crystallized entirely, some definite principles have been evolved: *Commissioner v. Tower,* 66 S. Ct. 532 (1946) and *Lusthaus v. Commissioner,* 66 S. Ct. 539 (1946).

The traditional concept for the taxation of income from property is the ownership of that property: *Lucas v. Earl,* 281 U. S. 111 (1930); *Poe v. Seaborn,* 282 U. S. 101 (1930); *Burnet v. Leininger,* 285 U. S. 136 (1932). For family partnerships, however, these Supreme Court decisions lay down a rule which is a sharp departure from and is irreconcilable with that test. It is immaterial that, under local property law, the wife owns an interest in the busi-

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ness. Instead, the test is the "reality" of the partnership as a *business venture* between husband and wife. The partnership meets this requirement if the wife (1) either invests capital originating with her; or (2) substantially contributes to the control and management of the business; or (3) otherwise performs vital additional services: *Commissioner v. Tower,* supra. Thus, a taxpayer who has carefully nurtured a family partnership of the type proscribed by the Supreme Court is now met with a tax deficiency. And, as if adding insult to injury, he may find the Commissioner contending that he is also liable for a gift tax on the interest transferred, despite the fact that the income attributable to it is still taxable to him in its entirety. Furthermore, if the partnership income distributable to his wife is taxable to him, it is conceivable that the courts may hold that he has made a further gift to his wife of the distributive share of the profits paid to her by the partnership. And if he is a man who is prone to contemplate the future, he may be disturbed to learn that upon his death, some estate tax implications may then arise, as a result of the transfer made to his wife when he created the partnership which gave promise of substantial tax savings when first conceived.

It may come as a surprise to many that there are such a number of possible gift and estate tax implications to the family partnership problem. Until recently, most of us were so intrigued by the opportunities for income tax savings to be enjoyed from such family arrangements that little heed was paid to other tax implications. Several recent cases, however, have focused our attention sharply upon the latter.

THE GIFT TAX IMPLICATIONS

(A) Statutory Provisions

Section 1000 of Chapter IV of the Internal Revenue Code, which is part of the Federal Gift Tax Statute, defines its general scope and provides:

> "(b) The tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; . . ."

Section 1002 which deals with "transfers for less than adequate and full consideration" states:

> "Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall, for the purpose of the tax imposed by this chapter, be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year."

Section 86.8 of Regulations 108, which implements and interprets "transfers for a consideration in money or money's worth" declares that:

> "Transfers reached by the statute are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration in money or money's worth to the extent that the value of the property transferred by the donor exceeds the value of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth. . ."

The valuation of the property involved in the transfer is an important factor. In family partnerships, the subject matter of the gift is an interest in the donor's business. The elements to be taken into account in determining its value are set forth in the Regulations. Section 86.19 (d) of Regulations 108 provides:

> "Care should be taken to arrive at an accurate valuation of any business which the donor transfers without an adequate and full consideration in money or money's worth, whether the interest transferred is that of a partner or of a proprietor. A fair appraisal as of the date of the gift should be made of all the assets of the business, tangible and intangible, *including good will,* and the business should be given a net value equal to the amount which a willing purchaser, whether an individual or a corporation, would pay therefor to a willing seller in view of the net value of the assets of the business and its demonstrated earning capacity. Special attention should be given to fixing an adequate figure for the value of the good will of the business . . ."

(B) Current Concept of Gifts

The fundamental characteristic of a gift at common law was "donative intent"—the intention on the part of the donor to make a gift. However, the United States Supreme Court in interpreting the Federal Gift Tax statute recently indicated that the presence of a donative intent is not necessary to establish a transfer as a gift under the statute. Congress, the Court declared, substituted the far more practical test of adequacy of consideration for purposes of the gift tax.

Mr. Justice Frankfurter, writing for the Court, in *Commissioner v. Wemyss*, 324 U. S. 303 (1945), said:

> "Sections 501 and 503 (predecessors of Sections 1000 and 1002, I. R. C.) are not disparate provisions. Congress directed them to the same purpose, and they should not be separated in application. Had Congress taxed 'gifts' simpliciter, it would be appropriate to assume that the term was used in its colloquial sense, and a search for 'donative intent' would be indicated. But Congress intended to use the term 'gifts' in its broadest and most comprehensive sense . . . Congress chose not to require an ascertainment of what too often is an elusive state of mind. For purposes of the gift tax it not only dispensed with the test of 'donative intent', it formulated a much more workable external test, that where 'property is transferred for less than an adequate and full consideration in money or money's worth' the excess in such money value shall for the purpose of the tax imposed by this title, be deemed a gift . . . And Treasury Regulations have emphasized that common law considerations were not embodied in the gift tax."

However, while a literal reading of Section 1002 of the Code might appear to embrace any transaction in which the respective considerations were not evenly balanced, the Commissioner himself has not taken that position. By his Regulations, he has eliminated from the sweep of the statute transfers in the ordinary course of business which are "bona fide, at arm's length and free from any donative intent": Regulations 108, section 86.8, supra.

As the Tax Court said in *Herbert Jones*, 1 T. C. 1207 (1943):

> ". . . we think that the present transfer was not within the purview of Section 503, supra (the predecessor of Section 1002). That section can scarcely mean that all arm's length business transactions, involving transfers of property, shall be subjected to scrutiny and, in every case where one party makes a bad bargain, he should have his misfortune increased by the imposition of a gift tax on his unfavorable balance from the transaction. The tax is imposed by authority of Section 501 (the predecessor of Section 1000). It is expressly limited to transfers 'by gift'. 'Gift' is not defined in the statute. The respondent, however, has himself defined the term as used in the controlling statute as excluding arm's length business transactions, such as is evidenced here, in which there was no donative intent."

Nor does the fact that the transaction takes place within the family unit conclusively prove that it is not bona fide and at arm's length. Such transactions are suspect but once having passed the careful scrutiny of the Commissioner, they should qualify as the type of business transaction removed from the scope of the gift tax statute. Thus, the petitioner had assigned to a partnership, composed of his wife, a brother, a cousin and himself, a royalty-free manufacturing license at its book value of $120,000. The Commissioner alleged that the value of the property was $1,000,000 and that the difference of $880,000 constituted a gift to the other partners. The evidence indicated that prolonged negotiations had been carried on among the parties and that the petitioner was anxious to take in the other partners because of their proven business capabilities. The Court held that the gift tax statute was inapplicable since the transaction was at arm's length, bona fide and motivated purely by business considerations: *Philip McKenna,* T. C. Memo. Op. CCH Dec. 14,765 (M) (1945).

In its opinion, the Court said:

> "The four parties to the negotiations which led to the formation of a partnership to carry on the business which had theretofore belonged to the petitioner, as a sole proprietor, were related by blood or marriage. Transactions between such parties may be carefully scrutinized for tax purposes. This one has been examined to see whether the petitioner gave his property away for substantially less than it was worth. A partnership is one of the most personal of business entities and these four persons exercised care in the selection of their partners with the result that no one but relatives was admitted . . . This record shows that the four negotiators, despite their relationship, exercised independent judgment in a businesslike and unsentimental way in reaching their agreement . . . thus, any difference in value between what the petitioner gave and what he received . . . came about inadvertently and was not intended by the petitioner as a gift."

On the other hand, where the family partnership fails to qualify as an arm's length, bona fide business transaction and the gift tax statute applies, what will be considered the subject matter of the gift?

The gift tax statute was intended to be all inclusive in its definition of property. The United States Supreme Court commenting on its scope, declared:

> "The language of the gift tax statute 'property . . . real or personal, tangible or intangible' is broad enough to include property, however conceptual or contingent.": *Smith v. Shaughnessy,* 318 U. S. 176, (1943); and that any "change of legal rights—and a shifting of economic benefits" can be the subject matter of a gift: *Guggenheim v. Burnet,* 288 U. S. 280, (1933).

Specifically, a transfer of a right to receive reasonably anticipated income can be the subject matter of a gift. Thus, where the taxpayer executed an assignment to her husband of any dividends that might be declared on certain stock between the date of the assignment and the close of the taxable year, the Court held the petitioner taxable on all dividends declared during that year since she remained the owner of the stock; and, furthermore, since the husband received the dividends, a gift was made, valued in the amount of the dividends paid to him during the effective period of the assignment: *Florence S. Hyman,* 1 T. C. 911 (1943).

INTRA-FAMILY PARTNERSHIPS

An irrevocable transfer to a wife of a capital interest in a partnership clearly constitutes a gift. The donee receives a vested interest in the property and upon liquidation can dispose of it as she pleases. In such cases, the only controversy revolves about the value of the gift: *Robert P. Scherer,* 3 T. C. 776 (1944).

However, in the variety of family partnership transfers possible, the problem of gift and estate tax liability is not so readily resolved. For instance, suppose under the family arrangement, a wife or son received no capital interest in the partnership but only a right to share in the profits or losses; or the wife or son contributed 25% of the capital but was entitled to enjoy 50% of the profits; or the wife is prevented from disposing of the partnership interest transferred to her?

Several recent Tax Court decisions have made these problems the center of a current tax controversy.

The first case was *William H. Gross,* 7 T. C. 837, decided on September 23, 1946, in which the Commissioner has acquiesced: I. R. B. 1946-25-12451. There, the taxpayer had developed a skin ointment. The product was manufactured and marketed successfully for a number of years under the trade name of "Mazon" by a corporation composed of the taxpayer and his wife. In 1941, the corporation was liquidated and its assets distributed to its two stockholders, the taxpayer receiving 80% and his wife 20% thereof.

Immediately following the liquidation of the corporation, the taxpayer and his wife joined by their daughter and son-in-law, a doctor, organized a partnership. The latter two had worked in the business previously but the nature of the services rendered by them is not set forth in the case as reported. In the partnership, the wife retained her 20% interest in the profits but the taxpayer's share was reduced to 60%. The daughter and son-in-law each received a 10% interest in the profits, which represented the amount by which the taxpayer's share of profits had been reduced; but neither acquired any part of the capital interest of the taxpayer in the partnership.

The Commissioner did not question the bona fides of the partnership for income tax purposes. His contention was, however, that the partnership interests transferred to the daughter and son-in-law were gifts subject to gift tax. Analyzing this position, the Tax Court, in its opinion, stated that this result would appear logical only if the shares of the partnership earnings assigned to the daughter and son-in-law were in excess of the value of their services to the partnership; and if such surplus of earnings came, not from the services of the remaining partners but from some asset of the business, not excluding good will, which could thus be treated, in part, as the subject matter of the transfer.

The Court thus evolved two rules to determine the existence and extent of the gift under such circumstances:

1. The interest transferred must exceed in value the services rendered by the transferee in return for which the transfer was made. Otherwise, there is full and adequate consideration for the transfer.

2. This excess in value, if it exists, must not result from the personal services of the transferor.

Applying these rules for determining the incidence of gift tax to the facts in this case, the Court pointed out that the crucial asset of the business was the trade-name, good will and formula of "Mazon" soap. That (trade name, etc.), from the capital standpoint, was what created the earnings in excess of the value of the services rendered by the parties. And that, under the partnership agreement, must remain in the business, even if the taxpayer withdrew. The opinion concluded that to the extent the interest in such future income was transferred, it constituted a taxable gift. The Court was spared the task of fixing the value of the gift because the parties had stipulated its valuation, in the event that it were found such a gift had been made.

The *Gross* case represents a clear situation where good will was indisputedly the chief asset of the business and was responsible for most of its earnings. In this respect, it is an example of one extreme phase of the problem.

In another case, decided simultaneously, the Tax Court had occasion to deal with the problem from the other extreme — where personal services were the chief income producing factor and where no good will existed: *Willoughby J. Rothrock,* 7 T. C. 848, (1946) in which the Commissioner has also acquiesced: I. R. B. 1946-25-12451.

This case involved Thomas Roberts & Co., a brokerage and commission business in food-stuff, which was first organized in 1858. It operated as a partnership until 1921, then as a corporation until 1927, when the partnership including the petitioners in the instant case was formed. The success of the business was attributable to the partnership's ability to obtain from canners the required quantities and quality of goods for sale. This in turn depended on the abilities, experience, personal reputation and special characteristics of the individual partners. The firm maintained no contractual relationship with any canner, and the parties had to solicit their accounts personally and be able to render satisfactory service. The partnership then sold such cannery output to a grocery chain and received a commission for its services.

In 1940 the firm was dealt a hard blow by the Federal Trade Commission, which issued an order against the partnership to cease and desist from the business of "purchase sales." The illegal act involved was the taking of a commission, allowance, or discount in connection with the sales. By December 1940, the petitioners were so discouraged by the business outlook that they discussed the possibility of terminating the partnership. Linton Thrasher, the son of one of the petitioners and associated with them in the business, was more optimistic and expressed confidence in the new techniques and sources which he had developed after the cease and desist order had been issued. His point of view was shared by John Rothrock, the son of the other petitioner. He also had been active in the business for a long time, had proven himself capable and had developed several valuable ideas of great benefit to the business. As a result, the new partnership was formed on January 1, 1941, in which Linton Thrasher was given a 20% interest, and John Rothrock a 15% interest. It was evident from the background and the negotiations carried on among the parties that petitioners believed that the partnership's future depended substantially upon the services to be rendered by Linton and John. The petitioners persuaded the Court that they would have gladly offered a like partnership interest to any other party having the same services to offer to the business.

It is important to note that in this case, unlike the *Gross* case, counsel for the petitioners dealt at length with the nature and value of the services rendered by the sons as well as with all other circumstances which tended to show that business considerations, rather than the family relationships, dictated the result. Again the issue, as in the *Gross* case, was whether the prospective shares of earnings of the sons in the partnership were attributable solely to their personal services; or partly to the contribution made by the existence and continuation of a going concern — in other words, to a share in presently valuable business prospects, comparable to good-will, which being the property of the old partnership was in some measure transferred to them as members of the new firm.

If there were no future earnings inherent in the business itself, there could be no gift tax liability for any one of several reasons. It would matter little if we were to conclude, as a matter of law, that there was a gift, but its value was so negligible as to eliminate it from practical consideration; or, substantial value being absent, the consideration passing for the transfer was full and adequate; or, there being no existing vehicle for the transmission of future earnings in such a purely personal service business, there was nothing which could be the subject of a gift.

Despite the fact that the business in the *Rothrock* case had been in existence for more than eighty years, the petitioners convinced the Court, and it so found, that the business, per se, possessed no substantial element of future earning power or good will. Its character and operation had been changed by the course of recent events. On the contrary, its income was derived primarily from personal services, so that different participants with similar abilities, experience and contacts could have organized a comparable venture and enjoyed a parallel success from their contribution of time, skills and services. The Court held for the taxpayer.

From the decisions of the Tax Court in *Gross* and *Rothrock* cases, these conclusions seem justified:

First, where good will is a valuable asset, a gift will be found to have been made to the extent that the transfrees share in the earnings which flow from such good will. As a corollary thereto, it follows that where the taxpayer makes a transfer of a capital interest, the value of the gift of the partnership interest transferred is not limited to that amount but in addition, will include the value of the right to share in the future partnership profits, to the exent that such profits are in excess of the contributions of the transferees to the partnership.

Second, in purely personal service types of businesses, where good will is nonexistent, no present gift results from the transfer of the right to share in future profits. However, it would seem to follow that actual payments of such profits would constitute gifts in the year paid.

INCOME TAX IMPLICATIONS OF FAMILY PARTNERSHIPS CREATED BY GIFTS OF INTERESTS

In the *Gross* case, the only issue before the Court was the gift tax consequence of the transfer. The Commissioner did not at that time question the bona fides of the partnership for income tax purposes. Let us suppose the Commissioner should now seek to attack the partnership from an income tax angle on the basis of the tests laid down by the Supreme Court in the *Tower* and *Lusthaus* decisions. Could it be argued that the Tax Court having imposed a gift tax liability on the transferor, the Commissioner was precluded from taxing the income to the transferor, at least to the extent that such income flows from the subject matter of the gift? The answer must be in the negative. Under the *Tower* and *Lusthaus* decisions, a husband may not escape income tax liability on the income of a family partnership even though he has made an irrevocable gift to his wife of an interest therein. *Commissioner v. Tower,* supra; *Lusthaus v. Commissioner,* supra; *W. B. Woosley,* T. C. Memo. Op. CCH Dec. 15,514 (M) (1946).

In fact, it would seem that the Commissioner's position would be strengthened by a prior adjudication of gift tax liability. He would then have no difficulty in showing that the transferee did not contribute either capital or substantial services. Thus not only would the taxpayer be required to pay a gift tax on the transfer but he would still remain taxable on the income flowing from such transfer.

GIFT TAX IMPLICATIONS OF FAMILY PARTNERSHIPS DECLARED INVALID FOR INCOME TAX PURPOSES

Consider now the reverse of this situation. The partnership has been declared invalid for income tax purposes. Even though the transfer of an interest in a family partnership has been so disregarded for income tax, there still may be gift tax liability provided that the transfer bore the characteristics of a gift. Where, however, the partnership is declared invalid for income tax purposes on the basis of an incomplete transfer, there cannot be any gift tax implications: *Earnest Strong,* 7 T. C. 953 (1946).

In the *Strong* case, the taxpayers, two husbands, had formed a four way partnership with their wives. The Tax Court held the partnership income taxable to the husbands on the express ground that there had been no complete and bona fide transfer of an interest in the business. Nevertheless, the government subsequently asserted that the transfers were subject to gift tax. The Tax Court refused to impose a gift tax insisting that the income tax case was res judicata as to the fact that a gift had not been made. The Court pointed out, however, that it did not necessarily follow that once a partnership has been found to be invalid for income tax purposes, no gift tax liability can be incurred. There may be cases in which completed gifts were made and on which gift taxes will lie but which, nevertheless, are invalid for income tax purposes.

Suppose the Commissioner, instead of seeking to tax as a gift the interest in the business allegedly transferred, had sought to tax the actual income paid to the wife by virtue of the provisions of the partnership agreement, even though such income was taxable to the husband? It is probable that he would have succeeded but that is a question which will be considered in a latter portion of this article.

GIFT TAX IMPLICATIONS OF PARTNERSHIP ADJUDICATED AS VALID FOR INCOME TAX PURPOSES

Where the partnership has been recognized as valid for income tax purposes, can a gift tax on the interest transferred be subsequently imposed? This question brings us to a consideration of *William F. Fischer,* Tax Court Docket No. 6470, which was argued before the Court on December 13, 1945, prior to the *Gross* and *Rothrock* cases but in which no decision has yet been rendered. The *Fischer* case represents the more typical of certain types of family partnerships. There, the taxpayer was the sole proprietor of a business which he organized in 1902. It was conducted under the name of Fischer Machine Company and was engaged in the manufacture and sale of specialized machines and tools. Capital as well as services was an important income producing factor. The taxpayer had two sons, who from the time they were 16 years of age, had worked in the business, at first during vacations, later full time. Their formal education and business training was directed towards their ultimate participation in the operation of the business. On January 1, 1939, the taxpayer and his two sons entered into a partnership agreement in which taxpayer contributed as capital the going business which had a net value of about $260,000 and each son paid in $32,000 in cash from his independent funds. Despite the disparity in capital contributions, all profits and losses were to be shared equally.

In the first Tax Court proceeding, the Commissioner contended that this was a sham partnership, that the sons should be considered as employees rather than partners, just as they were prior to 1939 and, therefore, all the profits should be taxed to the petitioner. The Court held, however, that the partnership was valid for income tax purposes: *William F. Fischer,* 5 T. C. 507 (1945). This decision was acquiesced in by the Commissioner: 1945 C. B. 3.

In its opinion, the Court concluded that even though this agreement was among members of a family, it, nonetheless, bore the characteristics of an arm's length, bona fide, business arrangement. The fact that petitioner contributed 80% of the capital, whereas the sons only put up 10% and all shared equally in the profits, was unimportant inasmuch as it was contemplated that the sons would gradually take over the responsibility of operating the business and would render most of the services.

As to the division of profits and losses, the Court continued, the transaction having qualified as a bona fide business arrangement, the parties, even though related, could freely agree among themselves as to the basis on which they would join together. Cited with approval was the following quotation from *Paul v. Cullum,* 132 U. S. 539 (1889) where the Supreme Court stated:

> ". . . it is entirely competent for them (the partners) to determine, as between themselves, the basis upon which profits shall be divided and losses borne, without regard to their respective contributions, whether of money, labor or experience, to the common stock. Story on Partnership §23, 24. Such matters are entirely within the discretion of parties about to assume the relation of partners."

In the pending *Fischer* proceeding before the Tax Court, the Commissioner contends that the transfer to the sons of the right to receive two-thirds of the net profits was without adequate and full consideration and that the present value of that right, in excess of the contribution of the sons in money and services to the partnership, is a gift. The taxpayer's position is that the transaction being a bona fide business arrangement, the gift tax statute is inapplicable.

It would seem to us that the Court should hold that no gift was made. This, upon the basis of the Tax Court's own prior adjudication that the agreement was bona fide and at arm's length, and the partnership valid for income tax purposes.

If the transaction was one motivated by business considerations alone, it is beyond the purview of the gift tax statute, irrespective of the adequacy of consideration: See Regulations 108, section 86.8, supra; *Philip McKenna,* supra.

Moreover, when a Court scrutinizes a family partnership to determine whether it meets all the tests of a bona fide business arrangement and finds that it qualifes as such, it would seem to follow that the contributions of the incoming partners, whether in the nature of services or capital, were adequate legally to support the partnership interest received.

A decision by the Court in the *Fischer* case that a gift was made to the sons, despite the fact that they contributed substantial capital and services, would preclude a father from taking his son into a business, where capital and services are of equal importance, without incurring liability for gift tax. Such a conclusion would be insupportable from the viewpoint of social, economic or national revenue policies. Where the transaction is at arm's length and motivated by business considerations only, the family relationship should not prejudice the parties.

PARTNERSHIP INVALID FOR INCOME TAX BUT WIFE RETAINS SHARE OF PROFITS

Still another problem suggests itself. Where the family partnership has been held to be invalid for income tax purposes and the wife receives the distributive share of income to which she is entitled under the partnership agreement, has the husband made a gift in the amount paid to her by the partnership?

This question has not yet been ruled upon by the courts. However, a family trust case involving a similar problem has been decided recently by the Tax Court and may have some relevancy. This case was before the Courts in two separate proceedings, one to determine the validity of the trust for income tax purposes (*Hogle v. Commissioner,* 132 F (2d) 66, [CCA-10, 1942]); and the other, the question of a gift tax: *James A. Hogle,* 7 T. C. 986 (1946). Hogle, as grantor, created a trust for the benefit of his children, reserving power of investment of the trust funds. The income of the trust resulted partly from dividends and interest on investments and partly from profits realized from trading in securities through a margin account managed by Hogle. The Commissioner sought to tax the entire income of the trust to the grantor. Distinguishing the trust income consisting of dividends and interest from that derived from trading on margin, the Court held the former taxable to the trust but attributed the profits from the margin trading to the personal efforts of the grantor and held such profits to be income taxable to him: *Hogle v. Commissioner,* supra.

In a subsequent proceeding in the Tax Court, the Commissioner sought to impose a gift tax and contended that the income realized from trading in securities on margin, having been declared taxable to the grantor but retained by the trust, constituted a gift to the trust when received by it.

The majority opinion of the Court stated that it did not follow as a matter of course that because income of a trust is taxable to the grantor, the original transfer in trust was incomplete as to such income for gift tax purposes; and that, therefore, a gift tax liability arises when such income is retained by the trust. The gift tax law and the income tax law are not so closely integrated. As the profits arose, they were impressed with the trust and the taxpayer could neither receive it nor gain any economic benefit therefrom. It was held that no gift was made of the income. Five judges dissented: *James A. Hogle,* supra. The Commissioner has published his non acquiescence in this decision: I. R. B. 1947-3-12475.

A careful scrutiny of the majority decision leads one to believe that the Court was not altogether certain of its conclusion that no gift of the income was made. This is evident from the Court's statement that: "The question here is not whether Hogle may have made a gift to the trusts of personal services which might be valued independently of the profits derived from the marginal trading," and thus indicated that had the Commissioner sought to value those services for gift tax purposes, such a contention might have been better received. The *Hogle* decision, however, has been followed in a subsequent case dealing with a similar situation: *Barbara M. Lockard,* 7 T. C. No. 135 (1946).

Whether the principles announced in the *Hogle* case will be applied to family partnerships which are invalid for income tax purposes remains to be seen.

The philosophy of the Court's opinion in that case is to be found in its conclusions that as the income arose, it was impressed with the trust to which it belonged. On the other hand, in a family partnership, where the income is taxable to the husband because he earns it, his agreement to share it with his wife operates merely as an assignment of income. Under such circumstances, the income may be taxable as a gift when received by the wife: *Lucas v. Earl,* 281 U. S. 111 (1930).

Thus, it would seem that in a situation such as the *Strong* case presents, where the family partnership is held invalid for income tax purposes on the basis of the incompleteness of the gift, actual payments of income may constitute gifts to the recipients.

Of course, where a gift tax has been paid on the partnership interest transferred, there should be no more gift tax liability on the transferee's distributive share of income, at least to the extent that such income is attributable to his interest in the partnership on which the gift tax was paid. However, under the rationale of the *Gross* case, it would seem that income payable to the transferee which does not flow from his interest therein, but which is attributable to the personal services of the transferor, would constitute a gift at the time paid.

ESTATE TAX IMPLICATIONS OF FAMILY PARTNERSHIPS

Thus far we have dealt with the gift tax implications of family partnerships. What of the possible estate tax problems? Some of these invite consideration.

Section 811 (c) of the Internal Revenue Code provides for the inclusion of property in the gross estate of the decedent:

> "(c) To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise . . . intended to take effect in possession or enjoyment at or after his death, or of which he has at any time made a transfer, by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death; (1) the possession or enjoyment of, or the right to the income from, the property or (2) the right, either alone, or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

In a recent case decided by the Tax Court, the taxpayer had converted his business previously conducted as a sole proprietorship into a partnership with his wife as a partner. The Commissioner sought to include the wife's interest in her husband's gross estate for Federal estate tax. His contention was that the decedent's transfer to his wife of an interest in his business was a gift to take effect at death and, therefore, subject to estate tax.

For many years, the decedent had been engaged in the business of manufacturing ladies' underwear. He withdrew $44,000 of cash from the business and gave it to his wife. On the same day, the two of them entered into an agreement to engage in the same business as partners for five years with the decedent as sole manager. While there was nothing in the partnership agreement to prevent the wife from withdrawing funds, actually she never withdrew any and took no part in the conduct of the business. The Commissioner maintained that the decedent had such control over the capital of the business, including the share standing in his wife's name, that the transfer of such capital to her *did not take effect in possession or enjoyment until the decedent died.*

The Tax Court decided that the partnership agreement gave the wife present rights in the partnership capital not dependent upon the death of the decedent; and pointed out that, in effect, the Commissioner had agreed that the gift was irrevocable since it was stipulated by the parties that the wife "contributed" the money to the partnership. She would first have to own it in order to contribute it, the court reasoned: *Estate of Louis Bendet,* T. C. Memo. Op. CCH Dec. 15, 143 (M) (1946). See also, *Rose v. Commissioner,* 65 F (2d) 616 (CCA-6, 1933); *Moorhouse,* 8 B. T. A. 964 (1927).

It is important to note that the validity of the partnership for income tax purposes had never been questioned. Suppose the Court had held in a prior adjudication that the entire partnership income was taxable to the husband, would the Court have reached an opposite conclusion?

Restraints by the husband upon the wife's free control of her partnership capital invite serious tax risks. Thus, where by the agreement, the wife is precluded from withdrawing funds or alienating her partnership interest, which the husband gifted to her, and full control is vested in the husband, there is grave danger that the courts might consider the transfer one which takes effect at death. In such event, notwithstanding the prior gift, the wife's partnership interest might be includible in the husband's estate for Federal estate tax purposes: Section 811 (c) of the Code.

Another estate tax problem which presents itself is the effect of the use by the wife of her share of partnership income, for the payment of premiums on life insurance which she purchased upon her husband's life. The threat of estate taxes to the estate of the insured-decedent lies in the application of the "premium payment test" as the basis for the inclusion of life insurance proceeds: See, Edward N. Polisher, Estate Planning and Estate Tax Saving, P. 53 (1943).

Section 811 (g) of the Internal Revenue Code provides that proceeds of insurance receivable by named beneficiaries, other than the estate, under policies upon the life of the decedent shall be included in the insured's estate where the policies are purchased with premiums or other consideration paid *directly or indirectly* by the decedent, in the proportion that the amount so paid bears to the total premiums paid for the insurance.

The Regulations state:

> "The purchase of insurance upon the life of the decedent is attributable to the decedent even though the premiums, or other consideration, are paid only indirectly by the decedent. As thus used, the phrase 'paid indirectly by the decedent' is intended to be broad in scope. For example, if the decedent transfers funds to his wife so that she may purchase insurance on his life, and she purchases such insurance, the payments are considered to have been made by the decedent even though they are not directly traceable to the precise funds transferred by the decedent . . ." Regulations 105, Section 81.27.

The cases interpreting this section of the Code are meager and were all decided prior to the incorporation of the premium payment test by the statute. The test seems to turn, however, on whether an understanding or agreement existed between the insured and the donee to use the gift for the purpose of paying premiums. Thus, where the insured makes annual gifts of income and the donee uses such income to pay the premiums, the inference would be strong indeed that an understanding existed between the parties as to the purpose of the gift. The same would be true where a gift of capital is made, the income of which approximates the premiums due. Such a theory is equally applicable to gifts of interests in family partnerships.

To illustrate, let us consider the following situation. A husband makes a gift to his wife of a share in the profits of a partnership. Such a partnership would be disregarded for income tax purposes since the wife contributed neither capital nor substantial services. Coincidentally with this transfer, the wife purchases insurance on her husband's life and thereafter uses her share of the profits to pay the premiums on the policy. Under these circumstances, the Commissioner may well contend that the transfer of the partnership interest was made pursuant to an understanding that the income would be used for that purpose; and that as a result, the insurance proceeds should be taxable in the husband's estate on the theory that he "indirectly" paid the premiums. Such a situation would be analagous to annual gifts of income which the wife uses to pay premiums on policies issued on her husband's life: See Regulations 105, Section 81.27.

CONCLUSION

Much of the terrain over which we have travelled in the foregoing discussion is uncharted tax territory. At several unrelated points, familiar landmarks in the form of the Commissioner's Regulations and decisions of the courts did exist. These formed fixed points from which to take bearings and to chart the development of the situations presented. From these points, also, the lines leading to our conclusions were extended. In the process, we observed with faithful logic, the philosophy of the pertinent regulations and decisions. If tax law were the result of the application only of such mental operations, the conclusions stated would truly forecast the ultimate disposition of the problems discussed. This could only obtain in an intellectual utopia. In the realistic world of present day taxation and in our current economy, other potent factors often influence the outcome, causing the conclusion to be diverted from the path of pure logic. The effect of these added elements must not be ignored. Only time and the decision of these problems by the constituted authorities, when presented in due course, will determine which factors were then dominant. The solution will turn accordingly.