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University of Arkansas · System Division of Agriculture
NatAgLaw@uark.edu · (479) 575-7646

An Agricultural Law Research Article

Post-Mortem Recognition of Informal Family Partnerships

by

Thomas Earl Geu

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Comment

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I. INTRODUCTION

Ideally, post-mortem tax planning should be an extension of a total estate plan. The goal of such planning is to leave the administered estate with minimal problems and maximal tax savings.[1] The personal representative is primarily responsible for marshalling the assets—paying debts, taxes, and administrative expenses—and then distributing the remaining estate to the beneficiaries.[2] Tax planning, however, does not cease with the de-

1. *See* Brackney, *Post-Mortem Tax Planning for Estates*, 15 WAKE FOREST L. REV. 581 (1979).
2. For purposes of this article, the definition of "personal representative" will be that adopted by the Nebraska Legislature: "Personal Representative in-

cedent's death, for the personal representative must make decisions which affect not only the estate tax return, but also the decedent's final income tax return, the estate's income tax return, and income tax returns of beneficiaries for years to come.[3]

Unfortunately, the deceased may not always have had an estate plan, or the plan may not have been fully developed to provide maximal tax benefits. While the best opportunity to conduct valuable estate planning passes with the decedent's death, post-mortem tax planning techniques are available to the personal representative.[4]

Post-mortem tax planning is especially important in the farm and ranch context. The typical farmer or rancher enters into numerous unique business arrangements with his employees, landlords, tenants, children, and spouse. To achieve maximal tax benefits, these arrangements must be properly classified. One method of classification is to treat a particular arrangement as an informal partnership. However, taxation as a partnership is not elective; rather, it is a consequence of the economic arrangement.[5]

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cludes executor, administrator, successor personal representative, special administrator, and persons who perform substantially the same function . . . ." NEB. REV. STAT. § 30-2209(33) (1979).

3. *See generally* Walsh, *Postmortem Estate Planning*, 37 N.Y.U. INST. FED. TAX'N 44 (1979). Traditional post-mortem estate planning includes the planning of the decedent's final income tax return, gift-splitting elections, fiduciary income tax or estate tax elections, fiscal year planning, planning of estate distributions, determination of the optimal time to terminate the estate, use of disclaimers, and the planning of qualified retirement plan distributions. *Id.*

For a summary check-list of post-mortem elections, see Johnson, *Post-Mortem Tax and Estate Planning Elections*, 42 MONT. L. REV. 199 (1981). *See also* ASOFSKY, POST-MORTEM ESTATE PLANNING (P.L.I. 1977); Bilson & Sorgenfrei, *Tax Problems Arising After Death*, 25 S. CAL. TAX INST. 531 (1973); Brackney, *supra* note 1; Buttrey, *Post-Mortem Tax Planning: A Guide To The Elections Available to Estates and Beneficiaries*, 40 J. TAX'N 148 (1974); Conway & Hale, *After-Death Tax Planning—Tax Options*, 301 TAX MGMT. (Portfolio) (BNA) (1974) (withdrawn for revision); Frimmer, *The Federal Disclaimer Rule—E. Pluribus Unum?*, 14 U. MIAMI INST. EST. PLAN. ¶ 400 (1980); Shapiro, *Post-Mortem Tax Planning*, 26 TUL. TAX. INST. (1977).

4. One commentator perceptively noted:

> The post-mortem tax-planning techniques available to the executor are not set out in the Internal Revenue Code but are the result of alternative courses of action available to the executor. The executor [or personal representative] must consider the interaction of the bodies of estate and income tax law with the selected tax-planning techniques. The administrative problems and tax objectives are not the same for any two estates, but because of the variety of tax-planning alternatives available to the executor, tax savings can be made in practically all of them.

Brackney, *supra* note 1, at 582.

5. *See* Streng & Bywaters, *Estate Planning After the Economic Recovery Tax Act of 1981*, 11-9th TAX MGMT. (Portfolio) (BNA) A-116 (1982). *See generally* W.

Unfortunately, "the partnership is an illusive creature of the law whose characteristics defy uniform definition and attempts to confine the partnership to an ironclad definition of universal application have proven fruitless."[6] Most of the litigation relating to partnership classification has focused on whether a particular economic arrangement is properly classified as a partnership for tax purposes, or more nearly resembles a nonentity relationship, such as the relationship between mere co-owners, or between an employee and an employer.[7]

The recognition of informal relationships for estate tax purposes determines whether the value of specific property will be included in the decedent's gross estate.[8] The impact that the recognition of informal relationships has on the gross estate has been magnified by recent changes in the federal estate tax law regarding the unlimited marital deduction, the increase in the exemption equivalent, and the restructured rate of taxation.[9]

The $600,000 unified credit equivalent makes the division of property between a husband and wife even more crucial than

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McKEE, W. NELSON, & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ch. 3 (1977).

6. Bock, *Farm Partnership Formation and Operation*, 3 AGRIC. L.J. 504 (1981).

7. Nelson, *The Tax Classifications of Partnerships: Distinguishing From Arm's-Length Economic Arrangements*, 40 N.Y.U. INST. FED. TAX'N. § 15.01 (1982).

8. *Compare* Craig v. United States, 451 F. Supp. 378 (D.S.D. 1978), *with* Kjorvestad v. United States, 47 A.F.T.R.2d (P-H) ¶ 81-1635 (D.N.D. 1981).

9. *See infra* note 51 and accompanying text. Recognition of partnerships also causes income tax ramifications. Specifically, problems arise when income tax elections are made by the wrong party. One commentator has stated that "[o]ne of the greatest dangers of failure to recognize that a particular arrangement is or may be a partnership for tax purposes is that tax elections may be invalid because they are made by the wrong party." Nelson, *supra* note 7, at § 15.02[1]. Nelson lists at least 14 elections that must be made by the partnership, as opposed to the partners. They include: (1) the election of an accounting method; (2) the method of cost recovery under I.R.C. § 168, and the recovery period under I.R.C. § 168; (3) the election to amortize the cost of pollution control equipment under I.R.C. § 169; (4) the inventory method; (5) the election, under I.R.C. § 1033, to reinvest condemnation proceeds in order to avoid the recognition of gain; (6) the election to treat the cutting of timber as a sale or exchange; (7) the election to expense intangible drilling costs; (8) the election, under I.R.C. § 179, to expense the cost of certain depreciable business assets; (9) the election to defer cancellation of indebtedness income under I.R.C. § 108(a)(5); (10) the election to expense land-clearing costs under I.R.C. § 182; (11) the election of a taxable year; (12) the election not to report gain on deferred payment sales under the installment provisions of I.R.C. § 453; (13) the election provided by I.R.C. § 333 with respect to the recognition of gain by qualifying shareholders in connection with certain one-month corporate liquidations; and (14) the election, under I.R.C. § 266, to capitalize interest and carrying charges. *Id.*

under prior law.[10] Before the recent estate tax changes, spouses were encouraged to direct their estates primarily toward their surviving spouses in order to take advantage of the marital deduction. The marital deduction effects a deferral of estate tax until the surviving spouse's death. The unified credit equivalent has made this strategy anachronistic for a couple who holds property valued in excess of $600,000. Such a couple should be advised to make use of the unified credit equivalent allowed for each of their respective estates. The waste of one unified credit, by a couple having combined estates larger than $1.2 million, would result in an unnecessary tax liability of at least $222,000.[11] Thus, while the maximum use of the unlimited marital deduction results in deferral of the estate tax, the result may be a significant increase in the aggregate estate tax.[12] Even though section 2523 has been amended to provide for an unlimited marital deduction between spouses for federal gift tax purposes, there may be an opportunity for significant post-mortem estate tax savings for decedents who have failed to execute new estate tax plans to take advantage of the recent changes. It is possible to reduce a decedent's estate tax liability by shifting property from the decedent's gross estate to an informal partnership. Although the estate planner can shelter $1.2 million of property by using a conventional by-pass trust,[13] the prospect of a more sharply progressive tax provides incentives to minimize the

10. *See* D. KELLEY & D. LUDTKE, ESTATE PLANNING FOR FARMERS AND RANCHERS § 4.26 (1980 & Supp. 1982).

11. The $600,000 unified credit, multiplied by the 37 percent minimum estate tax rate, equals $222,000. *See infra* note 51 and accompanying text.

12. For a detailed discussion of the mathematics of the marital deduction and the optimal allocation of property between the estate of the spouses, see Reinders, Boehlje & Harl, *The Marital Deduction: How Much Should You Qualify?*, 3 AGRIC. L.J. 262 (1981).

Commentators Backman and Frank suggest five factors to consider in determining the degree to which the unlimited marital deduction should be used: (1) inflation; (2) the age of the beneficiary; (3) the earnings on deferred taxes; (4) the role of appreciation; (5) the use of gift programs. Backman & Frank, *Five Factors to Consider in Determining How Much of the Unlimited Marital Deduction to Use*, 9 EST. PLAN. 194, 197 (1982).

13. The by-pass trust is "the basic structure of all arrangements which attempt to give the surviving spouse the maximal benefit of property owned by the decedent spouse without creating federal estate taxability of the survivor." D. KELLEY & D. LUDTKE, *supra* note 10, at § 4.15. Generally, property held separately by each spouse may be passed by will, revocable trust, or other devices at death so that the surviving spouse may have the benefit of the property up to the limits prescribed by Treas. Reg. § 20-2041-1(c) without its inclusion in the gross estate of the surviving spouse. The Regulation describes the nature of permissible retained controls and powers despite which the property will not be included in the survivor's estate. D. KELLEY & D. LUDTKE, *supra* note 10, at § 4.16.

value of property in both gross estates.[14] The maximum 50 percent tax rate applies in an estate where husband and wife have property worth approximately $2,250,000.[15]

The purpose of this comment is to discuss the interrelationship between the recognition of informal family farm partnerships[16] and the determination of the property to be included in a decedent's estate for federal estate tax purposes.[17] This article will briefly examine the structure of the estate tax system and proceed with a discussion of the impact which the recognition of informal family farm partnerships has on the computation of estate and income tax.

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14. *See generally* Simmons, *The Real Estate Partnership Freeze in Light of the Economic Recovery Act of 1981: A Guide for the Perplexed*, 60 TAXES 476, 479 (1982).
15. *Id.*
16. The scope of this Article is limited to the recognition of informal family farm partnerships. In recent years much has been written on the tax aspects of partnerships as well as the use of partnership as an estate planning device. The seminal works in the area of partnership taxation are W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 5, and A. WILLIS, J. PENNELL & P. POSTLEWAITE, PARTNERSHIP TAXATION (3d ed. 1982). For excellent commentaries dealing specifically with partnerships in the farm and ranch context, see J. O'BYRNE & C. DAVENPORT, FARM INCOME TAX MANUAL (6th ed. 1982). *See also* D. KELLEY & D. LUDTKE, *supra* note 10. *See generally* R. RICE & T. RICE, FAMILY TAX PLANNING (1981); Dugdale, *An Overview of Partnerships: An Alternative to Traditional Planning*, 42 MONT. L. REV. 247 (1981); Nash, *Family Partnerships: A Viable Planning Alternative*, 13 U. MIAMI INST. EST. PLAN. ¶ 1000 (1979).

    There are many sources which discuss the use of partnerships for the purpose of freezing value in estate planning. *See, e.g.*, Abbin, *The Value-Capping Cafeteria—Selecting the Appropriate Freeze Technique*, 15 U. MIAMI INST. EST. PLAN. ¶ 2000 (1981); *Dual Capital Partnerships As An Estate Planning Device*, 39 N.Y.U. INST. ON FED. TAX'N. § 54.00 (1981); *Partnership Capital Freeze—An Alternative to Corporate Recapitalization*, 13 U. MIAMI INST. EST. PLAN. ¶ 1800 (1979); Schiefly, *Partnership Recapitalization: Achieving A Capital Freeze*, 32 S. CAL. TAX INST. ¶ 500 (1980); Simmons, *supra* note 14; Comment, *Limited Partnerships: Estate Planning Vehicle for the Family Farm*, 59 NEB. L. REV. 55 (1980); Comment, *The Partnership Capital Freeze: An Examination of Control Retention by Donor Partners*, 59 NEB. L. REV. 709 (1980); Comment, *Estate and Gift Tax Valuation: Discounts of Partnership Interests*, 59 NEB. L. REV. 737 (1980).
17. Federal estate tax can generally be divided into four categories: (1) the determination of the property to be included in a decedent's estate and the valuation thereof; (2) the determination of the amount of deductions permitted the decedent's estate; (3) the determination of the gross estate tax; and (4) after the gross estate tax has been computed, the determination of the credits allowed the estate in arriving at the net estate tax. D. KAHN & L. WAGGONER, FEDERAL TAXATION OF GIFTS, TRUSTS AND ESTATES 3 (2d ed. 1982). *See generally* 85 C.J.S. *Taxation* § 1111 (1954).

II. THE FEDERAL ESTATE TAX

A. History of Federal Estate Taxation

The federal estate tax was first adopted in 1916. The laws were designed to enable the federal government to tax the transfer of property at death. The tax is measured by the value of the property transferred, and the rates are graduated.[18]

The federal estate tax of 1916, however, was not the first tax which the federal government imposed on the gratuitous transmission of wealth.[19] Earlier taxes were levied on the receipt of property, rather than its transfer. Thus, the transferees of property, as opposed to transferors, bore the tax burden. One obvious way of taxing the beneficiary of a gratuitous transfer is to include the receipt of gifts, bequests, and inheritances in taxable income. This was expressly done under the federal income tax of 1894. However, this form of taxation was in force for only one year before the Supreme Court held it unconstitutional.[20] The sixteenth amendment,[21] which became effective in 1913, enabled Congress to reinstate the income tax.[22] In doing so, Congress expressly excluded gifts, bequests, and inheritances from taxable income.[23]

In *New York Trust Co. v. Eisner*,[24] the Court upheld the constitutionality of the current federal estate tax. The Court held that, because the current scheme taxed the transfer of property, rather than its ownership, it was an indirect tax and did not have to be apportioned. Justice Holmes, delivering the opinion of the Court,

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18. *See* H. HARRIS, HANDLING FEDERAL ESTATE TAXES INCLUDING GIFT TAXES 4 (1959). *See generally* D. KAHN & L. WAGGONER, *supra* note 17; J. LEWIS, THE ESTATE TAX 1 (4th ed. 1979). For in-depth discussion of the general area of estate taxation, see A. CASNER, ESTATE PLANNING (4th ed. 1980); R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION (4th ed. 1978); D. WESTFALL, ESTATE PLANNING LAW AND TAXATION (1983).
19. Legacy and inheritance taxes are of ancient origin, dating back to the Roman Empire. H. HARRIS, *supra* note 18. For a complete discussion of the early inheritance tax, see M. WEST, THE INHERITANCE TAX (2d ed. 1908).

    The federal estate tax was enacted in 1916, and, despite the fact that the purpose of its enactment was to meet the "extraordinary expenditures for the Army and Navy" during World War I, it has continuously remained in effect. J. LEWIS, *supra* note 18, at 1.
20. Pollock v. Farmer's Loan & Trust Co., 158 U.S. 601 (1895).
21. U.S. CONST. amend. XVI.
22. D. KAHN & L. WAGGONER, *supra* note 17. *See* J. FREELAND, S. LIND & R. STEPHENS, FUNDAMENTALS OF FEDERAL INCOME TAXATION, 14-18 (3d ed. 1981).
23. "Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance." I.R.C. § 102(a) (1976). For proposals that transfer taxes should be included in the income tax structure, see McNulty, *A Transfer Tax Alternative: Inclusion Under the Income Tax*, 2 TAX NOTES 24-27 (1976); Halbach, *Accessions Tax Favored*, 2 TAX NOTES 29-31 (1976).
24. 256 U.S. 345 (1921).

relied extensively on *Knowlton v. Moore*,[25] in which the Court had similarly concluded, with respect to the federal inheritance tax of 1898, that a tax imposed on the transfer of property was an indirect tax, and was, therefore, not subject to apportionment.[26]

B. Estate Tax and Property Includable in the Gross Estate

Before entering the arena of estate planning theory and techniques, it is important to discuss the structure of the federal estate and gift tax.[27] All property owned, in whole or in part, by a citizen or a resident of the United States at the time of his death, must be included in his gross estate to the extent of the value of his interest in the property.[28] In addition, various types of property, even though not "owned" in the ordinary sense, must be included in the gross estate.[29] For example, property which is transferred with certain "strings attached" must still be included in the transferor's gross estate.[30] The Internal Revenue Code provides that the gross estate must include the value of property transferred by a decedent (excluding those transfers for which full and adequate consideration has been received) where the decedent has either retained the right to receive income from the property, or has retained the right to determine its ultimate possessor.[31] Furthermore, the gross estate must include the value of transfers of property which do not take effect until the transferor's death.[32] Fi-

25. 178 U.S. 41 (1900).
26. D. KAHN & L. WAGGONER, *supra* note 17.
27. Streng & Bywaters, *supra* note 5, at A-4.
28. I.R.C. § 2033 (1976). The Regulation to the Code provision states:

> The gross estate of a decedent who was a citizen or resident of the United States at the time of his death includes under Section 2033 the value of all property, whether real or personal, tangible or intangible, and wherever situated, beneficially owned by the decedent at the time of his death. . . . Real property is included whether it came into the possession and control of the executor or administrator [personal representative] or passed directly to heirs or devisees.

Treas. Reg. § 20.2033-1(a) (1982).
29. *See* Streng & Bywaters, *supra* note 5, at A-5.
30. *Id.* The value of the gross estate includes the value of property transferred with certain "strings attached" within the meaning of the "transfer" provisions. *See* I.R.C. § 2036 (1976) (transfers with a retained life estate); I.R.C. § 2037 (1977) (transfers taking effect at death); I.R.C. § 2038 (1977) (transfers with a retained power to alter, amend, revoke or terminate). These provisions apply primarily, though not exclusively, in the trust context. The value of the gross estate includes the value of all property with respect to which the decedent had, at the time of his death, a general power of appointment. *See* I.R.C. § 2041(b)(1) (1939) (defining a general power of appointment).
31. I.R.C. § 2036 (1976).
32. The value of the gross estate shall include the value of all property which the decedent has transferred (except for an adequate and full consideration in money or money's worth), if possession or enjoyment of the property by an-

nally, the gross estate must include property transferred by the decedent where the transfer was subject to change upon the death of the decedent.[33]

Three issues generally arise in determining whether a property interest should be included in an estate.[34] First, it must be determined whether a particular interest is subject to estate taxation. Because of the expansive nature of Internal Revenue Code section 2033, this issue presents few problems for the courts. As such, it is generally conceded that all of the decedent's property is taxable, unless external factors such as state law or the peculiar nature of the interest suggest a means for excluding the property from the gross estate.[35]

Second, it must be determined whether the decedent had a sufficient interest in the property to warrant its inclusion in the estate. This is almost exclusively a question of property law. The cases which address this question turn largely on common-law and statutory rights.[36]

Finally, if it is established that the decedent had a sufficient interest in the property, it must then be determined whether that interest continued until the time of his death. This is the most difficult estate tax question[37] as it involves interests which had begun to accrue or had come into existence near the time of decedent's death, but which had not yet come into the decedent's possession.[38]

A decedent's partnership interest must be included in the gross estate under section 2033. This result is clear under both the Code

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other can be obtained only by surviving the decedent, and if the decedent has retained a reversionary interest in the property, the value of which, immediately before his death, exceeds five percent of the value of the property. I.R.C. § 2037(a) (1962). I.R.C. § 2037(b) (1977) provides that, for the purposes of § 2037, the term "reversionary interest" includes a possibility that the *property* transferred by the decedent may return to him (or his estate), or may be subject to the power of disposition by him; but the term does not include a possibility that only the *income* from such a property may return to him, or become subject to a power of disposition by him. As to the valuation of such interest, see I.R.C. § 2037(b) (1977); Treas. Regs. § 20.2037-1(c)(3) (1958). For an in-depth analysis of I.R.C. § 2037, see Dodge, *Transfers Taking Effect at Death, (§ 2037)*, 256-2d TAX MGMT. (Portfolio) (BNA) (1981). For an in-depth analysis of I.R.C. § 2038, see Knickerbocker, *Lifetime Transfers with Retained Powers*, 50-3d TAX MGMT. (Portfolio) (BNA) (1980); Abramson, *Retained Life Interests*, 133-3d TAX. MGMT. (Portfolio) (BNA) (1979).

33. I.R.C. § 2038 (1977).
34. FEDERAL ESTATE AND GIFT TAXES EXPLAINED (CCH) ¶ 155 (1983) [hereinafter cited as FEDERAL TAXES].
35. *Id.* at ¶ 156.
36. *Id.* at ¶ 157. *See infra* notes 55-72 and accompanying text.
37. *Id.* at ¶ 158.
38. *Id.*

and the Regulations. The Regulation states that "[t]he gross estate of a decedent . . . includes, under section 2033, the value of all property, whether real or personal, tangible or intangible, and wherever situated, which is beneficially owned by the decedent at the time of death."[39]

The Tax Reform Act of 1976,[40] the Revenue Act of 1978,[41] and the Economic Recovery Tax Act of 1981[42] effected significant changes in the estate tax structure. The Economic Recovery Tax Act of 1981 had an immense impact on estate planners,[43] as it amended the marital deduction to allow unlimited tax-free interspousal transfers after December 31, 1981.[44] The dollar limitation on interspousal transfers was eliminated by the repeal of section 2056(c).[45] Current law permits qualified terminable interest property to qualify for the marital deduction.

The characteristics required for a qualified terminable interest property trust are the same as those required for a life estate power-of-appointment trust,[46] except: (1) there is no requirement

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39. Treas. Reg. § 20.2033-1(a) (1963). The subject of valuation of a partnership interest is beyond the scope of this article; however, for a brief introduction to the topic, see Lawson, *Family Partnerships*, 346 TAX MGMT. (Portfolio) (BNA) A-40 (1978). For a more detailed analysis in the farm and ranch context, see Harl, *Special Use Valuation of Farmland Under I.R.C. Section 2032A With Emphasis on Planning to Meet Pre-Death Requirements*, 16 U. MIAMI INST. EST. PLAN. ¶ 1500 (1982); Lewis, *Farm Property Valuations*, 38 N.Y.U. INST. FED. TAX'N § 39.00 (1980); Note, *Material Participation and the Valuation of Farm Land for Estate Tax Purposes Under the Tax Reform Act of 1976*, 66 KY. L.J. 848 (1977-1978).
40. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.
41. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763.
42. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.
43. Gingiss, *Marital Deduction Planning Under ERTA '81*, 60 TAXES 269 (1982).
44. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 301 (eliminating I.R.C. § 2056(c); redesignating I.R.C. § 2056(d) as § 2056(c); amending I.R.C. § 2523(a); and eliminating I.R.C. § 2523(f)). *See* FEDERAL TAXES, *supra* note 34, at ¶ 1001.
45. Gingiss, *supra* note 43.
46. *Id.* A similar provision is contained in I.R.C. § 2523 with respect to the gift tax marital deduction.

> The 1981 Act allows an estate or gift tax marital deduction for the value of "qualified terminable interest property" if the donor or decedent's executor [personal representative] so elects. Qualified terminable interest property is property passing from the decedent to a spouse who is entitled to all income from the property (or a portion thereof) for life, payable at least annually. . . . No person, including the spouse, can have the power to appoint any part of the property subject to the qualified income interest to any person other than the spouse during the spouse's life. However, the 1981 Act permits creation or retention of any powers over all or a portion of the corpus, provided that all such powers are exercisable only on or after the spouse's death. Further, income interests granted for a term of years, or a life interest subject to termination upon occurrence of a

for a general power-of-appointment, and (2) the personal representative must elect on the estate tax return in order to have the interest qualify. If the surviving spouse is the only noncharitable beneficiary of a charitable remainder trust, the beneficial interest will also qualify for a marital deduction.[47]

The Economic Recovery Tax Act of 1981 also increased the unified credit[48] against the estate tax,[49] starting with an exemption equivalent[50] of $225,000 in 1982, and increasing annually to $600,000 in 1987.[51] The minimum gross tax rate was increased to thirty-seven percent for an estate in excess of the exemption equivalent. The maximum rate was lowered to fifty percent, with an annual reduction which will be fully effective in 1985.[52]

The tax treatment of joint tenancies between spouses has been changed by the 1981 Act so that the estate of the first spouse to die will include only one-half of the value of a qualified joint interest in property.[53] The 1981 Act simplified the definition of qualified joint

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condition (such as remarriage), are not qualified income interests under the 1981 Act.

FEDERAL TAXES, *supra* note 34, at ¶ 1003.

47. Gingiss, *supra* note 43. *See* I.R.C. § 2056(b)(8) (1981).
48. A single unified rate schedule and credit for estate and gift taxes now applies. I.R.C. §§ 2010, 2505 (1981). The credit must be applied first to gift taxes on lifetime transfers, and any remainder to the extent not used will be available at death to offset estate taxes. FEDERAL TAXES, *supra* note 34, at ¶ 15.
49. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 299 (*amending* I.R.C. §§ 2010, 2505 (1976)).
50. The "exemption equivalent" is the amount which may be bequeathed or given away without incurring a federal transfer tax. Therefore, the unified credit which may be deducted from the taxable estate is transformed into an equivalent exemption amount which may be used to reduce the gross estate for conceptual planning purposes. *See* Gingiss, *supra* note 43, at 269 n.6.
51. I.R.C. § 2001 (1981). The credit will be expanded over six years as follows:

Year	Credit	Exemption Equivalent
1982	$ 62,800	$225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987	192,800	600,000

The Act also amended I.R.C. §§ 403(a)-(b), 691(c), 2012(b), 2056(b)-(d), 2523(a), and 2602(c) to create an unlimited marital deduction for gift and estate tax purposes. Simmons, *supra* note 14.

52. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 300 (*amending* I.R.C. § 2001 (1978)).
53. I.R.C. § 2040(b) (1981). Under prior joint interest tax law:

> With regard to the estate tax, prior to 1976 the property was includable in the gross estate of the first to die except to the extent that contribution could be shown by the survivor. Subsequent to the Tax Reform Act of 1976, if the property was a "qualified joint interest," only one-half was included in the first estate. To be a qualified joint

interest. Under the Act, any interest in property held solely by spouses as joint tenants with rights of survivorship, or as tenants by the entirety is, considered a qualified joint interest. Thus, the estate of a decedent who dies after 1981 will include one-half the value of property jointly owned with a spouse, regardless of which spouse furnished consideration for the property.[54] Alternatively, spousal property may be characterized as partnership assets, in which case the decedent partner's estate includes that part of the assets proportionate to his or her partnership interest.

III. DETERMINATION OF PARTNERSHIP STATUS

A. Federal Tax Law Determinative of Status

Although federal tax law governs the incidence and rate of taxation, state law generally defines the existence of the property rights which are subject to federal taxation.[55] In many instances, the applicability of state law is clear because the taxing statute expressly refers to state law.[56] However, under some Code provisions, federal law supersedes state law in order to provide a uniform federal definition for a term which is also defined disparately from state to state.[57] In most instances federal statutes are silent as to the relevancy of state law. When federal statutes are silent, parties must look to state law, for lack of other governing law, in order to determine whether a requisite property characteristic exists.[58] The Supreme Court has ruled that in the absence of a decision by a state's highest court, a federal court must apply what it finds the state law to be after giving "proper regard" to the decisions of the lower courts of that state.[59] However, "proper re-

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> interest, the property had to be created by decedent and his spouse as joint-tenants or tenants by the entirety, but only if the creation constituted a gift (or, in the case of real property, only if an election to treat the creation as a gift had been made).

Gingiss, *supra* note 43, at 276. *See* Campfield, *Estate Planning for Joint Tenancies*, 1974 DUKE L.J. 669 (1974); Maxfield, *Some Reflections on the Gift and Estate Taxation of Jointly Held Property*, 34 TAX LAW 47 (1980); Note, *Estate Tax Section 2040: Homemaker's Contribution to Jointly Owned Property*, 29 TAX LAW 623 (1976).

54. I.R.C. § 2040(b) (1981); FEDERAL TAXES, *supra* note 34, at ¶ 503.
55. Streng & Bywaters, *supra* note 5, at A-4. *See* Doll, *Partnership and Taxation and State Partnership Laws: A Checklist of Problems*, 20 N.Y.U. INST. FED. TAX'N 789 (1982); Sullivan, *Conflicts Between State Partnership Laws and the Internal Revenue Code*, 15 TAX L. REV. 105 (1959).
56. For a general discussion of the interaction between federal estate tax law and state property law, see D. KAHN & L. WAGGONER, *supra* note 17, at 37.
57. *See, e.g.*, I.R.C. § 2041(b) (1939); I.R.C. § 2514(c) (1976) (defining the "general powers of appointment").
58. *See, e.g.*, Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955).
59. Commissioner v. Bosch, 387 U.S. 456 (1967). In this case the outcome of the

gard" does not necessarily establish state trial court decisions as binding upon the federal courts. Instead, as the Court stated in *Commissioner v. Estate of Bosch*,[60] "where the federal estate tax liability turns upon the character of a property interest held and transferred by the decedent under state law, federal authorities are not bound by the determination made of such property interest by a state trial court."[61]

Although state law governs many property law questions, federal tax law controls issues concerning entity relationships.[62] Long before the 1954 enactment of subchapter K of the Internal Revenue Code,[63] the Supreme Court ruled that federal law was controlling on issues involving income taxes. In *Hecht v. Malley*,[64] and *Burk-Waggoner Oil Association v. Hopkins*,[65] the Court held that "Massachusetts Trusts" were "associations" within the meaning of the Revenue Act of 1918, and, therefore, were taxable as corporations even though they were considered partnerships under state law.[66] Thus, state law classification of an arrangement as a partnership, does not necessarily establish a partnership for federal tax purposes.[67]

In *Commissioner v. Tower*,[68] the Supreme Court upheld the Tax Court's denial of partnership status for a husband and wife despite a partnership agreement which was valid under state law. The Court rejected the taxpayer's argument that state property law

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controversy hinged on whether a release of a general power of appointment executed by Mrs. Bosch was invalid. If so, she would have enjoyed a general power of appointment at her husband's death, and the trust would therefore qualify for the marital deduction. While the Tax Court proceeding was pending, Mrs. Bosch filed a petition in the Supreme Court of New York for settlement of the trustee's account. She also sought a determination as to the validity of the release under state law. The Tax Court, with the Commissioner's consent, abstained from making its decision pending the outcome of the state court action. The state court found the release valid and the Tax Court then accepted the state court decision as an adjudication of the property rights involved, and therefore permitted the deduction. The court of appeals affirmed and the Supreme Court reversed the decision.

60. 387 U.S. 456 (1967).
61. *Id.* at 457.
62. *See* Comment, *Informal Partnerships: Their Status Under Federal and State Tax Law*, 59 NEB. L. REV. 464, 468 (1980).
63. The federal income tax treatment of partnerships is set forth in subchapter K of the Internal Revenue Code of 1954. For a detailed discussion of subchapter K, see Spada & Ruge, *Partnerships—Statutory Outline and Definition*, 161-2d TAX MGMT. (Portfolio) (BNA) (1975).
64. 265 U.S. 144 (1924).
65. 269 U.S. 110 (1925).
66. Burk-Waggoner Oil Ass'n v. Hopkins, 269 U.S. 110, 113-14 (1925); Hecht v. Malley, 265 U.S. 144, 161 (1924).
67. *See* Comment, *supra* note 62, at 464.
68. 327 U.S. 280 (1946).

should control the validity of a partnership for federal tax purposes, stating: "Michigan cannot, by its decisions and laws governing questions over which it has final say, also decide issues of federal tax law and thus hamper the effective enforcement of a valid federal tax levied against earned income."[69]

Even though state law is not determinative, it may be considered as a *factor* in determining whether a partnership exists for federal tax purposes. In *Buckley v. United States*,[70] a professor of journalism and one of his former students had made an oral agreement to share profits in a newspaper publishing company. Under local law, it was not necessary that a partnership be predicated upon a written agreement; rather, it could be inferred from the circumstances and conduct of the parties. Thus, it was clear that a partnership existed under state law.[71] The Tax Court expressly considered the partnership status of the arrangement under state law, in holding that a partnership also existed for federal tax purposes. The court recognized the importance of state law, stating: "[W]hether a partnership existed for federal tax purposes is to be determined by federal law, although local law is relevant to such an analysis."[72]

B. Partnership Definitions

The federal system of taxation includes four distinct forms of taxation: income taxation, estate taxation, gift taxation, and generation-skipping taxation.[73] Prior to enactment of the Tax Reform Act of 1976,[74] the estate tax and the gift tax statutes operated inde-

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69. *Id.* at 288. *See also* United States v. Kintner, 216 F.2d 418 (9th Cir. 1954) (holding that, despite its state law status, an association of medical doctors was taxable as a corporation).

    A husband-wife partnership may be recognized even if, under state laws, the spouse may not legally become a partner. Rev. Rul. 58-243, 1958-1 C.B. 255.
70. 76-1 T.C. (CCH) ¶ 9473 (W.D. Tex. 1976).
71. The professor exercised managerial prerogatives, negotiated financing for the business, and permitted the business to be represented to the community as a partnership. 76-1 U.S.T.C. (CCH) ¶ 9573, at 84,313. *See generally* Comment, *supra* note 63, at 470.
72. 76-1 T.C. (CCH) ¶ 9473 (W.D. Tex. 1976) at 84,313. *See, e.g.*, Haley v. Commissioner, 203 F.2d 815 (5th Cir. 1953).

    > For tax purposes the nomenclature under state law may have a little influence because the question whether there is a partnership will be decided by the standards of the Federal tax law, not state law. A partnership under tax law is a much broader concept than the common law or statutory entity found in most states. It includes all joint ventures and will frequently embrace organizations that are not partnerships under state law. (Citations omitted).

    J. O'BYRNE & C. DAVENPORT, *supra* note 16, at § 900.
73. D. KAHN & L. WAGGONER, *supra* note 17, at 1.
74. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

pendently. Each system had its own structure, rate of taxation, and rules. The estate tax applied to testamentary transfers, while the gift tax applied to inter vivos transfers. This dual transfer tax system was modified by the 1976 Act which provided for both a unified rate schedule and a unified credit for estate and gift taxes.[75] Despite these changes, the structure of the system remains essentially that of a dual transfer tax system.[76]

The federal income tax statutes govern many of the issues which arise in the gratuitous transmission of wealth.[77] Although the Code specifically states that gross income shall not include the value of property acquired by gift, bequest, devise, or inheritance,[78] the exclusion from gross income does not apply to *income* from property so received.[79] The federal income tax also affects the basis of property received gratuitously.[80] Finally, the income tax rules govern both the income and deductions "in respect of a decedent."[81]

Although there is a lack of symmetry among the four federal taxes, the courts have generally applied the same tests in both estate tax and income tax cases in order to determine whether a partnership exists.[82] It should be noted that tests applied under

75. *See supra* notes 48-52 and accompanying text.

76. D. KAHN & L. WAGGONER, *supra* note 17, at 2.

77. *Id.* at 1.

78. I.R.C. § 102 (1976). *See supra* note 23 and accompanying text.

79. I.R.C. § 102(b)(1) (1976).

80. I.R.C. § 1014 (1976).

81. Section 691(a) provides for the treatment of various income items as "income in respect of a decedent." I.R.C. § 691(a) (1976). Such items are to be treated as gross income when subsequently realized. They are also includable in the decedent's estate for federal estate tax purposes. These rules apply, in general, to items of income which have accrued in the economic sense to a cash-basis taxpayer before his death, but which have not been received by him and, accordingly, are not taxable to him under his method of accounting. The purpose of such rules is to provide equality of treatment between cash-basis and accrual-basis taxpayers. *See* Treas. Reg. § 1.691(a)-(b)(1) (1982). For a detailed analysis of income in respect of a decedent, see Miller, *Income in Respect of a Decedent-General*, 32-2d TAX MGMT. (Portfolio) (BNA) (1981).

I.R.C. § 691(b) provides that deductions for business expenses, interests, taxes, and depletion which are not properly allowable on the decedent's last tax return are allowed to the estate of the decedent in the taxable year when paid. I.R.C. § 691(b) (1976).

82. *Compare* Krause v. Commissioner, 497 F.2d 1109 (6th Cir. 1974); Payton v. United States, 425 F.2d 1324 (5th Cir. 1970), *cert. denied*, 400 U.S. 957 (1970); *and* United States v. Ramos, 393 F.2d 618 (9th Cir. 1968) (income tax cases), *with* United States v. Neel, 234 F.2d 395 (10th Cir. 1956); Eckhard v. Commissioner, 182 F.2d 547 (10th Cir. 1950); *and* Craig v. United States, 451 F. Supp. 378 (D.S.D. 1978) (estate tax cases). Another commentator has reached the same conclusion in Comment, *supra* note 62, at 475.

the partnership income tax provisions[83] look to whether the transferee possessed dominion and control over the partnership interest. The courts have focused on the substance of the transaction and have held that "legal niceties" should be ignored. Instead, the practicalities of the economic and social relationship are emphasized in order to effectuate the purpose of the federal income tax.[84] However, "legal niceties" appear to be of greater significance in the estate tax area under section 2033.[85]

The significance of "legal niceties" for purposes of estate tax may be illustrated by the litigation concerning a Louisiana estate. In *Aldrich v. Usury*,[86] the court held that federal law controlled its determination that no partnership existed. On appeal, the Fifth Circuit held that the estate tax issue was whether the decedent owned a partnership interest under state law. It was not relevant whether he was recognized as a partner for income tax purposes.[87] On remand, the district court found that no partnership existed under Louisiana law, therefore, the personal representative was required to include the entire business interest in the decedent's gross estate.[88] The added requirements of section 2033 created a distinction between partnership status for income tax and estate taxation. Although it is important to recognize this potential difference in treatment, it is generally not of any great significance regarding the following discussion concerning the determination of partnership status.

C. Distinction Between Informal and Family Partnerships

The Internal Revenue Code defines "partnership" by both inclusion and exclusion, stating that a partnership includes "a syndicate, group, pool, joint-venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on,"[89] but excludes "a corporation, trust, or estate."[90] Like unrelated taxpayers, family members may

83. I.R.C. §§ 704(e) (1939), 761 (1977), & 7701(a)(2) (1976).
84. Lawson, *supra* note 39, at A-40.
85. *Id.* *See supra* notes 28-39 and accompanying text.
86. 211 F. Supp. 330 (E.D. La. 1962).
87. Aldrich v. United States, 346 F.2d 37 (5th Cir. 1965).
88. Aldrich v. Usury, 256 F. Supp. 508 (E.D. La. 1966), *aff'd per curiam sub nom.* City Nat'l Bank v. United States, 383 F.2d 341 (5th Cir. 1967).
89. I.R.C. §§ 761 (1977), 7701(a)(2) (1976).
90. *Id.* An informal partnership is recognized as a partnership for tax purposes even though it has few of the common characteristics usually exhibited by a formal partnership, i.e., formal written agreement, partnership name, etc.

The Regulations discuss four corporate characteristics for use in the classification of a business entity as a corporation or association. The Regulations establish a relatively mechanical test by which an unincorporated organization will be classified as a corporation. Such a business entity shall

contribute capital or services for the conduct of a business and receive recognition as a partnership for federal tax purposes. However, the tax law also recognizes that family partnerships may serve as a vehicle for taxpayers who wish to divide income or property among related persons in order to take advantage of lower progressive tax brackets or to escape taxation entirely.[91] To pre-

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be classified as a corporation if it has more of the significant corporate characteristics than non-corporate characteristics. The four corporate characteristics, discussed in some detail in the Regulations, are continuity of life, centralized management in a representative capacity, limited liability, and free transferability of interest. Treas. Reg. § 301.7701-2 (1982). Generally, the Regulations follow Morrissey v. Commissioner, 296 U.S. 344 (1931). The Court in *Morrissey* noted the following characteristics of a corporation or association: (1) associates; (2) an objective to carry on a trade or business and divide the profits; (3) continuity of life of the enterprise, notwithstanding the death, disability or withdrawal of its members; (4) the opportunity for centralized management by representatives of the owners; (5) the privilege of limited liability for the owner; and (6) free transferability of beneficial interests in the organization. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 2.02 (1979). *See generally* Nelson, *supra* note 7, at § 15.01; Fox, *The Maximum Scope of the Association Concept*, 25 TAX L. REV. 311 (1970); Lyons, *Comments on the New Regulations on Associations*, 16 TAX. L. REV. 441 (1961); Zarky, *Unincorporated Organizations Taxable as Corporations*, 13 S. CAL. TAX INST. 277 (1961). For a more detailed treatment of trusts as associations, see B. BITTKER & J. EUSTICE, *supra* at ¶ 2.03; Stephens & Freeland, *The Federal Tax Meaning of Estates and Trusts*, 18 TAX L. REV. 251 (1963).

The distinction between associations and partnerships becomes particularly important in the tax-shelter planning area. *See, e.g.*, I.R.S. Letter Rul. (CCH) 8304036 (Oct. 22, 1982); I.R.S. Letter Rul. (CCH) 8304013 (Oct. 19, 1982); I.R.S. Letter Rul. (CCH) 8239152 (July 1, 1982); I.R.S. Letter Rul. (CCH) 8239151 (July 1, 1982); I.R.S. Letter Rul. (CCH) 8239141 (July 1, 1982); I.R.S. Letter Rul. (CCH) 82318118 (June 28, 1982); I.R.S. Letter Rul. (CCH) 8201038 (Oct. 7, 1981).

For a discussion of two recent cases where the Tax Court recognized arrangements as joint-ventures, rejecting the form of transaction asserted by the taxpayers, see *Tax Court Recognizes "Hidden" Joint Venture*, 8 EST. PLAN. 83 (1981).

91. W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 5, at ¶ 14.01. "Accordingly the tax law of family partnerships is essentially a reflection (or perhaps more accurately, a refraction) of the assignment-of-income principle." *Id.*

The Regulations provide the following general guidelines in the context of recognition of family partnerships for tax purposes:

> The production of income by a partnership is attributable to the capital or services, or both, contributed by the partners. The provisions of subchapter K, chapter 1 of the Code, are to be read in the light of their relationship to section 61, which requires, *inter alia*, that income be taxed to the person who earns it through his own labor and skill and the utilization of his own capital.

Treas. Reg. § 1.704-1(e)(1)(i) (1982).

The assignment-of-income principle generally requires that income will be taxed to the person who earned it or owned the income-producing property. *See* M. CHIRELSTEIN, FEDERAL INCOME TAXATION ¶¶ 8.01-.02, 9.02 (1980).

vent the evasion of tax liability,[92] Congress promulgated special statutory rules to supplement the partnership recognition rules.[93] In a post-mortem farm and ranch context, any partnerships which may exist commonly does so between family members. Therefore, it is particularly important to discuss the family partnership rules of section 704(e).

D. Definition of a Family Partnership

1. *Early Common Law*

In the early 1900's the courts were willing to find the existence of a family partnership if the arrangement constituted a partnership under local law. This situation began to change in the 1930's, however, when the Supreme Court handed down several landmark decisions concerning the "assignment of income".[94] A number of

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The leading cases in the area are Lucas v. Earl, 281 U.S. 111 (1930), and Helvering v. Clifford, 309 U.S. 331 (1940). Many of the elements of these cases are involved when a parent seeks to make his children partners, causing partnership distributive shares to be taxed to the children, rather than the parent. These elements are also present in partnership arrangements between husbands and wives. In the husband and wife income context, however, the impact of the assignment-of-income principal has been reduced by I.R.C. § 170, which provides that a husband and wife may elect to file a joint income tax return. *See* I.R.C. § 170 (1980). The principle still has great impact in other related party transactions. It also has an analogous application in the estate tax area, even between spouses.

"Tax reduction is not evil if you do not do it evilly." Gunn, *Tax Avoidance*, 76 MICH. L. REV. 733, 733 (1978) (quoting Murphy Logging Co. v. United States, 378 F.2d 222, 223 (9th Cir. 1967)). In contrast to the quotation, Professor Gunn gave an almost purely negative critique of what he considers to be a loophole in the income tax. "Where there is an income tax, the just man will pay more and the unjust less on the same amount of income." McMahon, *Expanding the Taxable Unit: The Aggregation of the Income of Children and Parents*, 56 N.Y.U. L. REV. 60, 60 (1981) (quoting PLATO, REPUBLIC, bk. 1, 343-d (Jowett Trans. 1888)).

Another commentator writing on special valuation of farm land for estate tax purposes, *see* I.R.C. § 2032A (1981), noted: "One is reminded, when reading the debates on this provision, that taxation is a means of economic, social, and political ends as well as a means to raise revenue." Note, *Material Participation and the Valuation of Farm Land for Estate Tax Purposes Under the Tax Reform Act of 1976*, 66 KY. L.J. 848, 854 (1978). The commentator chose to include in his hypothesis a quote from Mortimer Caplan, former Director of the Bureau of Internal Revenue who said: "There is one difference between a tax collector and a taxidermist—the taxidermist leaves the hide." *Id.* at 848.

92. *See supra* note 90.
93. I.R.C. §§ 761 (1977), 7701(a)(2) (1976).
94. *See, e.g.*, Blair v. Commissioner, 300 U.S. 5 (1937); Burnett v. Wells, 289 U.S. 670 (1933); Burnett v. Leininger, 285 U.S. 136 (1932); Corliss v. Bowers, 281 U.S. 376 (1930); Commissioner v. Olds, 60 F.2d 252 (6th Cir. 1932); Crane v. Commissioner, 19 B.T.A. 577 (1930); Phelps v. Commissioner, 13 B.T.A. 1248 (1928). *See also* Lawson, *supra* note 39, at A-3.

Internal Revenue Service victories created a substantial body of law which was used to restrict the use of income-splitting devices. And, due to the income-splitting opportunity created by a family partnership, a series of rules was designed to limit the availability of family partnership status.[95] As a result of an inconsistent position taken by the Tax Court, irreconcilable decisions[96] left a confusing body of law. Because of conflicting decisions regarding the recognition of family partnerships, the Supreme Court agreed to review the question,[97] and in 1946, the Court handed down *Commissioner v. Tower*[98] and *Lusthaus v. Commissioner*,[99] which provided guidelines for both taxpayers and the Internal Revenue Service.[100]

In *Commissioner v. Tower*,[101] a business had been operated by the taxpayer as a corporation for several years, the taxpayer owned eighty-nine percent of the outstanding stock. Due to substantial profits and increased taxes, the taxpayer was advised to reorganize the business as a partnership, with his wife as a principal partner. In order to reorganize the business, the taxpayer transferred 38 percent of the corporate stock to his wife on the condition that she place the corporate assets represented by those shares into the new partnership. The corporation was liquidated and a limited partnership was formed, with the taxpayer contributing 51 percent of the capital as a limited partner, and an unrelated third party contributing the remainder of the capital. In its analysis of the arrangement, the Court recognized that "[t]here can be no question that a wife and a husband may, under certain circumstances become partners for tax, as for other, purposes."[102] However, in order to limit the growing number of arrangements which were clearly devised to split income, the Court required that the wife either invest capital which originated from her, or, she must contribute substantially to the control and management of the business, or otherwise perform vital additional services.[103]

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95. Lawson, *supra* note 39.
96. *Compare* Tower v. Commissioner, 3 T.C. 396 (1944), *with* Johnston v. Commissioner, 3 T.C. 799 (1944). *See also* J. RABKIN & M. JOHNSON, 2A FEDERAL INCOME, GIFT, AND ESTATE TAXATION § 6.05 (1982).
97. *See* Z. CAVITCH, 1 BUSINESS ORGANIZATIONS WITH TAX PLANNING § 9.04[2] (1982).
98. 327 U.S. 280 (1946).
99. 327 U.S. 293 (1946).
100. Commissioner v. Tower, 327 U.S. 280, 284 (1946). For further discussion, see Lawson, *supra* note 39.
101. 327 U.S. 280 (1946).
102. *Id.*
103. *See generally* Spada & Ludtke, *Dispositions of Partnership Interests—Gifts, Incorporations, Etc.*, 286 TAX MGMT. (Portfolio) (BNA) A-9 to -10 (1973).

Lusthaus v. Commissioner,[104] decided on the same day as *Tower*, involved a similar factual setting. As in *Tower*, the Commissioner had challenged the validity of a family partnership for federal income tax purposes. Affirming the Tax Court, the Supreme Court held that the parties had failed to create a valid partnership, finding that the partnership arrangements were merely superficial and did not actually change the husband's economic interest in the business. As a result of *Tower* and *Lusthaus*, the taxpayer had to show that the wife had contributed either original capital or vital services to the entity in order for a family partnership to be sustained.[105]

2. *The* Culbertson *Decision*

In response to the lower courts' disagreement as to the proper interpretation of the *Tower-Lusthaus* "original capital and vital services" test,[106] the Supreme Court reviewed the test in 1949, in another landmark decision, *Commissioner v. Culbertson*.[107] In *Culbertson*, Coon and Culbertson were partners in a cattle-breeding operation. Because Coon was seventy-nine years of age and in ill health, he agreed to sell his interest in the business to Culbertson, if Culbertson would promise, in turn, to sell a one-half interest to Culbertson's four sons. Culbertson complied with Coon's wishes and sold a one-half interest to his sons in exchange for a promissory note. The operation conducted business as a partnership, but only one son supplied services to the operation. The promissory note was paid off with profits from the operation and gifts from Culbertson.[108]

The Court reaffirmed the *Tower* decision in part,[109] holding that one must contribute either capital or services to be recognized as a partner. The Court, however, rejected the contention that *Tower* and *Lusthaus* established specific criteria for the determination of partnership status, and indicated that the lower court's refusal to recognize a family partner unless he contributed either "vital services" or "original capital" to the partnership was an error in emphasis.[110] The *Culbertson* Court held that:

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standards supposedly established by the *Tower* case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provi-

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104. Lusthaus v. Commissioner, 327 U.S. 293 (1946).
105. *See* D. KELLEY & D. LUDTKE, *supra* note 10, at § 3.58.
106. *See supra* notes 101-05 and accompanying text.
107. 337 U.S. 733 (1949).
108. For a discussion of *Culbertson*, see Lawson, *supra* note 39.
109. Commissioner v. Culbertson, 337 U.S. 733 (1949).
110. *See* W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 5, at ¶ 14.01[2].

> sions, their statements, the testimony of disinterested persons, 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—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.[111]

Following *Culbertson* the status of family partnerships was even less clear than it was before.[112] If original capital or vital services had been contributed, partnerships were generally upheld, but in the absence of these factors, courts focused on the true intentions of the parties.[113] The definition of "intent" accounted for much of the difficulty in the family partnership cases decided prior to 1951. Even now, "intent" to be a partner is requisite, since a partnership is a contractual relationship. Although objective facts—such as participation, formalities, and representations—may be evidence of intent, those factors do not themselves become the criteria.[114] Thus, a determination of partnership status for federal tax purposes is viewed primarily as a question of the subjective intent of the parties involved in the arrangement,[115] even though the Code fails to expressly refer to intent.[116]

3. *Congressional Response to* Culbertson

In 1951 Congress moved to end the confusion surrounding the validity of family partnerships for *income tax* purposes, by enact-

111. 337 U.S. 733, 742 (1949).
112. Z. CAVITCH, 1 BUSINESS ORGANIZATIONS WITH TAX PLANNING § 9.04[2][c] (1982).
113. Stanchfield v. Commissioner, 191 F.2d 826 (8th Cir. 1951); Batman v. Commissioner, 189 F.2d 107 (5th Cir. 1951), *cert. denied*, 342 U.S. 877 (1951); Feldman v. Commissioner, 186 F.2d 87 (4th Cir. 1950); Barrett v. Commissioner, 185 F.2d 150 (1st Cir. 1950); Slifka v. Commissioner, 182 F.2d 345 (2d Cir. 1950); Funai v. Commissioner, 181 F.2d 890 (4th Cir. 1950).
114. For further discussion, see J. RABKIN & M. JOHNSON, *supra* note 96, at § 6.06.
115. *See, e.g.*, Dorothy L. Huckle, 37 T.C.M. (P-H) ¶ 240, 244 (1968) (existence of a partnership is a "pure question of fact" and "the intent of the parties is the most important factor to be considered").

According to decisions of other courts, intent may be evidenced by the following objective factors: (1) joint contribution of capital or services for the purpose of carrying on a trade or business; (2) sharing of profits and losses; (3) mutual control of the business; (4) the agreement between and among the parties and their conduct; (5) representations of partnership status to third persons; (6) separate books of accounts for the enterprise; and (7) holding title to the business property in the partnership name. *See, e.g.*, Adams v. United States, 328 F. Supp. 228 (D. Neb. 1971); Ray S. Robinson, 44 T.C. 20, 34-35 (1965), *acq.* 1970-2 C.B. xxi; Hubert M. Luna, 42 T.C. 1067, 1077-78 (1964); Lucia Chase Ewing, 20 T.C. 216 (1953), *aff'd on other grounds*, 213 F.2d 438 (2d Cir. 1954). *See also*, Spada & Ruge, *supra* note 63, at A-5.

116. Spada & Ruge, *supra* note 63, at A-5.

ing Code section 704(e)(1).[117] As explained in the Committee Report,[118] the purpose of section 704(e)(1) was:

> [T]o harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business . . . [and to make 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.[119]

Section 704(e)(1) thus creates a two-pronged test which recognizes a person as a partner for income tax purposes if: (1) he owns a capital interest in a partnership, in which (2) capital is a material income-producing factor,[120] whether such interest was acquired by purchase or gift. Congress has thus abolished the "original capital" test for partnerships, in which capital is a material income-producing factor, at least for the purposes of income taxation.

4. *Impact of Section 704(e)(1) on Family Farm Partnerships*

Because farming is a capital-intensive occupation,[121] it seems obvious that section 704(e)(1) will almost always apply to farm and ranch enterprises. This is affirmed by a regulation which states that capital is a material income-producing factor "if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership."[122] Capital is generally considered a material income-producing factor if a partnership's business requires "substantial investment in plant, machinery, or other equipment."[123]

117. I.R.C. § 704(e)(1) (1976) provides: "A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person."
118. *See* S. REP. NO. 781, 82d Cong., 1st Sess. 39, *reprinted in* 1951 U.S. CODE CONG. & AD. NEWS 2008, 2008-09. *See generally* Note, *Family Partnerships and the Revenue Act of 1951*, 61 YALE L.J. 541, 544-51 (1952).
119. S. REP. NO. 781, 82d Cong., 1st Sess. 38, 39 (1951); H.R. REP. NO. 586, 82d Cong., 1st Sess. 32 (1951).
120. I.R.C. § 704(e)(1) (1976).
121. Capital normally is a material income-producing factor in a farm or ranch partnership, since such operations are capital intensive. D. KELLEY & D. LUDTKE, *supra* note 10, at § 7.47.

> The Woodbury partnership was in the ranching and farming business, and the capital contributions to it consisted of ranch land, farm machinery, and cattle. Without belittling the valuable services contributed by Glen and Leo to the partnership, the quality of the land, the efficiency of the machinery and the development of the cattle were critical to its success. Thus we think the capital contributed to this partnership was "a material income-producing factor" within the intendment of section 704(e)(1).

Woodbury v. Commissioner, 49 T.C. 180, 191 (1967).
122. Treas. Reg. § 1.704-1(e)(1)(iv) (1982).
123. *Id. See* Reddig v. Commissioner, 30 T.C. 1382 (1958); Hartman v. Commis-

However, the determination of whether capital is a material income-producing factor in the business of a partnership is to be determined on a case-by-case basis with reference to all relevant facts and circumstances.[124]

The second prong of the partnership test of section 704(e)(1) focuses on whether the partner owns a "capital interest." The Regulation defines a "capital interest in a partnership" as "an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership."[125] It is important to note that ownership may be attained by either purchase or gift.[126] Furthermore, the Regulation states:

> If the reality of the transfer of interest is satisfactorily established, the motives for the transaction are generally immaterial. However, the presence or absence of a tax-avoidance motive is one of the many factors to be considered in determining the reality of the ownership of a capital interest acquired by gift.[127]

The Regulations have established a number of tests to determine whether a donee or purchaser actually owns a partnership interest that has been transferred to him. No single factor is determinative; the reality of ownership can only be judged in light of the transaction as a whole.[128] The factors expressly delineated by the Regulations include: (1) substantial participation in the control and management of the business;[129] (2) actual distribution to a partner of the entire amount or a major portion of the taxpayer's distributive share of the business income for the partner's sole use and benefit;[130] and (3) conduct of the business as a partnership.[131]

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sioner, 43 T.C. 105 (1964) (employment of capital to finance inventory in accounts receivable was "material").

124. Treas. Reg. § 1.704-1(e)(1)(iv) (1982).

125. Treas. Reg. § 1.704-1(e)(1)(v) (1982). In Nichols v. Commissioner, 32 T.C. 1322 (1959), it was suggested that a wife's community property interest and property utilized in her husband's business, would be regarded as capital ownership for purposes of determining whether she and her husband were partners in community property states. *But see* Hornback v. United States, 298 F. Supp. 977 (D. Mo. 1969).

126. I.R.C. § 704(e)(1)-(2) (1976); Treas. Reg. § 1.704-1(e) (1982).

127. *Id.*

128. Treas. Reg. § 1.704-1(e)(2) (1982). *See also* Z. CAVITCH, BUSINESS ORGANIZATIONS WITH TAX PLANNING § 9.04[4] (1982).

129. Treas. Reg. § 1.704-1(e)(2)(iv) (1982).

130. Treas. Reg. § 1.704-1(e)(2)(v) (1982).

131. Treas. Reg. § 1.704-1(e)(2)(vi) (1982):

> Conduct of Partnership Business. In determining the reality of the donee's ownership of a capital interest in a partnership, consideration shall be given to whether the donee is actually treated as a partner in the operation of the business. Whether or not the donee had been held out publicly as a partner in the conduct of the business, in relations with customers, or with creditors or other sources

The Committee Reports recognized that cases would arise where the gift or sale of a partnership interest was a mere sham.[132] Therefore, Congress specifically provided that "[t]he amendment leaves the Commissioner and the courts free to inquire in any case whether the donee or purchaser actually owns the interest in the partnership which the transferor purports to have given or sold him."[133] Finally, Congress recognized that cases would arise "where the transferor retains so many of the incidents of ownership that he will continue to be recognized as a substantial owner

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of financing, is of primary significance. Other factors of significance in this connection include:

(a) Compliance with local ownership, fictitious names, and business registration statutes.

(b) Control of business bank accounts.

(c) Recognition of the donee's rights and distributions of the partnership property and profits.

(d) Recognition of the donee's interest in insurance policies, leases, and other business contracts in litigation affecting business.

(e) The existence of written agreements, records, or memoranda, contemporaneous with the taxable year or years concerned, establishing the nature of the partnership agreement and the rights and liabilities of the respective partners.

(f) Filing of partnership tax returns as required by law.

However, despite formal compliance with the above factors, other circumstances may indicate that the donor has retained substantial ownership of the interest purportedly transferred to the donee.

Id.

In Acuff v. Commissioner, 35 T.C. 162 (1960), *aff'd*, 296 F.2d 725 (6th Cir. 1961), the failure to comply with all these formalities of conveyancing and recording *contributed* to the denial of recognition of the partnership.

Note that the filing of partnership tax returns as required by law is only a factor to which consideration will be given in determining whether a partnership exists. Rev. Proc. 81-11, 1981-1 C.B. 651, sets forth the procedures under which partnerships with ten or fewer partners will not be subject to the penalty imposed by I.R.C. § 6698 for failure to file a partnership return.

> A partnership composed of ten or fewer partners of a type that has not historically filed a partnership return, such as a family farm partnership, or, in some cases, co-ownerships of property will be considered to have met the reasonable cause test and will not be subject to the penalty imposed by section 6698 of the Code for the failure to file a partnership return, provided that the partnership of any of the partners establishes, if so requested by the Service, that all partners have fully reported their shares of the income, deductions, and credits of the partnership on their timely-filed income tax returns.

Rev. Proc. 81-11, 1981-1 C.B. 651.

The Service's position reflects that of the Conference Committee Report concerning I.R.C. § 6698. *See* H.R. REP. NO. 95-1800, 95th Cong., 2d Sess. 221, *reprinted in* 1978-3 C.B. 521, 555. *See also* H.R. REP. NO. 95-1445, 95th Cong., 2d Sess. 75, *reprinted in* 1978-3 C.B. 181, 249; S. REP. NO. 95-1263, 95th Cong., 2d Sess. 106, *reprinted in* 1978-3 C.B. 315, 404.

132. S. REP. NO. 781, 82d Cong., 1st Sess. 33, *reprinted in* 1951 U.S. CODE CONG. & AD. NEWS 2000, 2000.

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

of the interest which he purports to have given away."[134]

Regulation section 1.704-1(e)(1)(iii)[135] provides that controls retained by the donor are important in determining whether the donor has relinquished ownership of a capital interest.[136] The Regulation specifically delineates four types of controls which tend to negate the reality of a transfer of partnership interests.[137] These types of control relate to the distributions of partnership income, the sale or liquidation of the donee's interests, the management of assets essential to partnership business, and management powers.[138] The legislative history of section 704(e)(1) indicates that the retention of a particular control by the donor or a restriction on the donee's ownership should affect the income tax liability of a family partnership *only* if it is not a normal or customary incident of membership status in a partnership of unrelated parties.[139]

In *Commissioner v. Culbertson*,[140] the Supreme Court addressed the issue of real ownership by the donee, concluding that "whether he is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise."[141] Similarly, the Regulation emphasizes the donee's con-

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134. S. REP. NO. 781, 82d Cong., 1st Sess. 33, *reprinted in* 1951 U.S. CODE CONG. & AD. NEWS 2000, 2000. For a general overview of the legislative history see R. RICE & T. RICE, *supra* note 16, ch. 16, at § 31.

135. Treas. Reg. § 1.704-1(e)(1)(iii) (1982):

> Requirement of Complete Transfer to Donee. A donee or purchaser of a capital interest in a partnership is not recognized as a partner under the principles of Section 704(e)(1) unless such interest is acquired in a *bona fide* transaction, not a mere sham for tax avoidance or evasion purposes . . . . To be recognized, a transfer must vest dominion and control of the partnership interest in the transferee. The existence of such dominion and control in the donee is to be determined from all the facts and circumstances. . . . Transactions between members of a family will be closely scrutinized, and the circumstances, not only at the time of the purported transfer but also during the periods preceding it and following it, will be taken into consideration in determining the *bona fides* or lack of *bona fides* of the purported gift or sale. A partnership may be recognized for income tax purposes as to some partners but not as to others.

Id.

See, e.g., Ginsberg v. Commissioner, 502 F.2d 965 (6th Cir. 1974); Krause v. Commissioner, 497 F.2d 1109 (6th Cir. 1974); Payton v. United States, 425 F.2d 1324 (5th Cir. 1970), *cert. denied*, 400 U.S. 957 (1970); Ballou v. United States, 370 F.2d 659 (6th Cir. 1966); Parker v. Westover, 248 F.2d. 490 (9th Cir. 1957).

136. For a general discussion of controls retained by the donor, see Spada & Ludtke, *supra* note 103, at A-11.

137. *See, e.g.*, W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 5, at ¶ 14.03.

138. Treas. Reg. § 1.704-1(e)(ii) (1982).

139. H.R. REP. NO. 586, 82d Cong., 1st Sess. 33 (1951); S. REP. NO. 781, 82d Cong., 1st Sess. 40, *reprinted in* 1951 U.S. CODE CONG. & AD. NEWS 2000, 2000.

140. 337 U.S. 733 (1949).

141. *Id.* at 747.

trol over income as being essential to a valid partnership. The Regulation states that the income tax liability of a family partnership may be affected by "[r]etention of control of the distribution of amounts of income or restrictions on the distribution of amounts of income (other than amounts retained in the partnership annually with the consent of the partners, including the donee partner, for the reasonable needs of the business)."[142] If the donor of a partnership capital interest limits the donee's right to "liquidate or sell his interest in the partnership at his discretion without financial detriment,"[143] it may be inferred that the donor has retained sufficient control over the donated interest to continue to be treated as the owner for income tax purposes. However, reasonable business restrictions may be imposed on the disposition of partnership interest, particularly if the restrictions are binding on both the donor and the donee.[144]

The Regulation further states that the donor's retention of control over assets essential to the business will be a factor in determining the existence of a partnership.[145] The Regulation does not elaborate on this requirement except by citing "assets leased to the alleged partnership"[146] as an example. It should be noted that Mimeograph 6767[147] gave a similar, though narrower, example of essential assets, referring to assets "leased at will or for a relatively short term."[148] By retaining the right to withdraw the essential assets, the donor effectively retains the right to cause a termination of the partnership business, thus rendering the donee's partnership interest valueless. Therefore, it is logical to conclude that the retention of a right to withdraw essential assets would jeopardize the validity of the partnership.

Finally, explicit in the Regulation, is the retention of management powers.[149] Retention of business management control or voting control by the donor, as is common in ordinary business relationships, is not necessarily inconsistent with normal relation-

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142. Treas. Reg. § 1.704-1(e)(2)(ii)(a) (1982). It is at least interesting to note that in the context of a case requiring interpretation of the Medicaid regulations Judge Friendly stated that "[t]here should be no such form of reference as 45 C.F.R. § 248.3(c)(1)(ii)(B)(2) . . . a draftsman who has gotten himself in such a position requiring anything like this should make a fresh start." Freidman v. Berger, 547 F.2d 724, 727 n.7 (2d Cir. 1976). The tax regulations are replete with such forms of reference.
143. Treas. Reg. § 1.704-1(e)(2)(ii)(b) (1982).
144. *See* Middlebrook v. Commissioner, 13 T.C. 385 (1949); Bellamy v. Commissioner, 14 T.C. 867 (1950).
145. Treas. Reg. § 1.704-1(e)(2)(ii)(c) (1982).
146. *Id.*
147. 1952-1 C.B. 111.
148. *Id.* at 114.
149. Treas. Reg. § 1.704-1(e)(2)(ii)(d) (1982).

ships among partners (provided the donee is free to liquidate his interest at his discretion without financial detriment).[150] But, just as the retention of management control *by the donor* indicates that the donor has retained effective ownership of the donated capital interest, substantial participation *by the donee* in the control and management of a partnership's business "is strong evidence of a donee partner's exercise of dominion and control over his interest."[151]

Whether a donor's retained control over gifted partnership interests is accomplished directly, or indirectly, it should be noted that such retained control will subject the arrangement to close scrutiny by the Internal Revenue Service.[152] Therefore, a donor in an inter vivos transfer cannot avoid the problem by utilizing a related entity to control the partnership.[153] The Regulation prohibits such indirect control by a donor.[154]

E. Relationship Between Income Tax and Estate Tax Treatment

In the post-mortem estate planning context, the issue of retained control under income tax statutes interrelates with retained control under the estate tax statutes.[155] For example, under Code section 2036(a)(1), the retention of a right to the income from property conveyed by gift will cause the property to be included in the donor's gross estate.[156] Furthermore, under Code section 2038(a)(1), and the Regulations thereunder, property will be included in a decedent's gross estate when the decedent has retained the power to transfer the enjoyment of the property.[157] Thus, if a donor receives substantially all of the partnership income or retains the right to determine the recipient of such income, the Service may seek to include any partnership interest in the donor's gross estate.[158]

The partnership income tax regulations acknowledge that a minor can be a partner for tax purposes, even if his interest is not held in trust.[159] This acknowledgment adds weight to the position

150. *Id.*
151. Treas. Reg. § 1.704-1(e)(2)(iv) (1982).
152. Treas. Reg. § 1.704-1(e)(2)(iii) (1982).
153. *See* Lawson, *supra* note 39, at A-10.
154. Treas. Reg. § 1.704-1(e)(2)(iii) (1982).
155. *See supra* notes 28-38 & 86-88 and accompanying text.
156. I.R.C. § 2036(a)(1) (1976).
157. I.R.C. § 2038(a)(1) (1976); Treas. Reg. § 20.2038-1 (1982).
158. *See* I.R.S. Letter Rul. (CCH) 7824005 (Mar. 2, 1978). *See also* D. KELLEY & D. LUDTKE, *supra* note 10, at § 7.48b.
159. Treas. Reg. § 1.704-1(e)(2)(vii) (1982). *See, e.g.*, Finlen v. Healy, 187 F. Supp. 434 (D. Mont. 1960); Green v. Arnold, 87 F. Supp. 255 (N.D. Tex. 1949), *aff'd per curiam*, 186 F.2d 18 (5th Cir. 1951).

that informal parent-child partnerships are valid. However, the minor must be shown to be "competent to manage his own property and participate in any partnership activities in accordance with his interest in the property."[160] It may be difficult for the typical parent-child partnership to meet this criterion; it may be impossible to demonstrate that the minor had sufficient dominion and control over the interest to be recognized as its owner for tax purposes.[161]

Of course, not all post-mortem recognition of partnerships will be found in a donor-donee context. In *Craig v. United States*,[162] the federal district court recognized the existence of an informal partnership based on evidence of typical farm wife services, and the usual understanding between the farm husband and wife that the fruits of the arrangement were owned equally. The issue arose as to the respective ownerships of the husband and wife in their *personal* property, because most of the real property was owned in joint tenancy. The court found that the wife had substantially contributed to the acquisition of the family property, and that the husband and wife had intended to join income and labor as equal partners, in order to establish and enlarge their family farm. The court emphasized the fact that very little was taken from the farm for the couple's personal enjoyment; rather, the fruits of their labor were reinvested in the farm.[163]

In the recent case of *Estate of Guy Kjorvestad, Sr.*,[164] the federal district court found that there was no credible evidence of an informal farm partnership between the husband and wife. As a result, the court allowed the taxation of all farm property in the decedent husband's estate, rather than one-half of the property, as proposed by the wife.[165] Although the court found that the wife had contributed to the farm operations by performing such tasks as occasionally milking the cows, selling eggs, supervising butchering and preparing meals, the court concluded that these services could not serve as adequate and full consideration in money, or money's worth, for a claim to a partnership interest in the farming operation.[166] On the contrary, the court found that the wife's primary responsibilities were essentially domestic in nature, and that

160. Treas. Reg. § 1.704-1(e)(2)(vii) (1982).
161. *See* Pflugradt v. United States, 310 F.2d 412 (7th Cir. 1962); Spiesman v. Commissioner, 260 F.2d 940 (9th Cir. 1958); Bialock v. Commissioner, 35 T.C. 649 (1961).
162. 451 F. Supp. 378 (D.S.D. 1978).
163. For a thorough discussion of *Craig*, see D. KELLEY & D. LUDTKE, *supra* note 10, at § 3.68.
164. 47 A.F.T.R.2d (P-H) ¶ 81-1635 (D.N.D. 1981).
165. *Id.*
166. *Id.* at ¶ 81-1637.

she had little control over the actual operation of the farm. The court found that the decedent had maintained sole control over farming operations, since he had personally supervised the business aspects of the farm operation. Testimony revealed that the decedent had made crop selection decisions, kept the books, hired and paid farm labor, and managed the financial decisions for the farming operation.[167] The court recognized that the farm had expanded markedly after the marriage, but concluded that the wife had contributed no material assets to cause the expansion.[168] The court relied on *Culbertson*,[169] in concluding that no partnership existed.[170]

Many cases decided under joint-tenancy tax law may be analogized to a partnership context.[171] In *Estate of Jack Robins Ensley*,[172] the decedent's widow argued that all of the property owned jointly as of the date of death was acquired during her marriage to the decedent, that she had contributed toward this acquisition in the form of services rendered to the business, and that her participation was equal to that of the decedent. The Tax Court stated that, where a husband and wife operate a business under a partnership or other agreement to share profits, and jointly-held property is acquired with the profits of that business, each spouse's services constitute full and adequate consideration for the funds received from the other, and that each used the value of the consideration to purchase the property.[173] The court found that the petitioner and the decedent had informally agreed to share profits, and that her services were equal in value to those performed by the decedent. However, the court also stressed that the petitioner had not proved the monetary value of her services or traced profit from the business as the source of funds for jointly-owned property. Therefore, only a very small portion of the contested property was excluded from the gross estate.[174]

In a similar case, *Estate of Everett Otte*,[175] the Tax Court held that the work of a surviving farm wife constituted consideration in money, or money's worth, for one-half of the property held by her

167. *Id.*
168. *Id.*
169. *See supra* notes 106-116 and accompanying text.
170. 47 A.F.T.R.2d (P-H) ¶ 81-1635, 81-1639 (D.N.D. 1981).
171. *See supra* notes 26-27 and accompanying text. *See, e.g.*, United States v. Neel, 235 F.2d 395 (10th Cir. 1956); Singer v. Shaughanessy, 198 F.2d 178 (2d Cir. 1952); Rogan v. Kammerdiner, 140 F.2d 569 (9th Cir. 1944); Berkowitz v. Commissioner, 108 F.2d 319 (3d Cir. 1939); Kihchel v. United States, 105 F. Supp. 523 (W.D. Pa. 1952).
172. 36 T.C.M. (CCH) 1627 (1977).
173. *Id.* at 1631.
174. *Id.*
175. 41 T.C.M. (P-H) ¶ 72-317 (1972).

and her husband as tenants by the entirety. This decision concerned a tract of land which had been held in the husband's name, individually, until it was placed in joint-tenancy shortly before death. Although *Otte* presented the issue of joint-tenancy, rather than recognition of a partnership, the decision seems to implicitly recognize a common-law theory of partnership.[176]

In *Otte*, the court emphasized that the parties had each contributed services to the management and operation of the farming enterprise.[177] The parties had pooled their earnings in order to purchase substantially all of the real and personal property of the farm operations. Furthermore, all of the farm debts were paid out of farm earnings jointly realized by the parties.[178] The court found that the surviving wife had contributed to the farm operations by assuming full responsibility for a chicken and egg production process, as well as by taking an *active* role in the management of other aspects of the farming operations.[179] The court expressly found that "her activities . . . were more extensive than those of an ordinary housewife not residing on a farm."[180] Thus, it appears that the proper involvement standard may be that of an "average" family, rather than that of an "average" farm family.

In *Woodbury v. Commissioner*,[181] a father-son partnership was recognized where the father had contributed about $100,000, and the son $300,000, to the venture. Although the son was a minor, he had performed labor and participated in the management of the

176. The common law can be stated as follows:

> Ordinarily, real estate bought with partnership funds, for partnership purposes and appropriated to partnership uses or entered and carried in the accounts of the firm as partnership assets, is regarded in equity as partnership property, irrespective of the name in which legal title is taken.

68 C.J.S. *Partnerships* § 72 (1954).

This area of tax law also seems to parallel divorce law. The spouses, in dissolution, may also have legally recognized business interests in property that are equivalent to ownership. When the spouses jointly operate a business, a partnership may exist. *Gerlach v. United States*, 34 A.F.T.R.2d (P-H) ¶ 74-5132 (Ct. Cl. 1973). As a partner, each spouse owns a portion of the partnership property. Whether a partnership exists is a question of fact. If one spouse receives property as a gift from the other spouse during the marriage, the donee spouse is the owner of that property. Even if the title is not changed, the donee may have legal ownership of the property. 1982 *P-H Divorce Taxation* ¶ 6205. Note, however, the concept of marital property as a property interest in the context of divorce law is not relevant for federal tax purposes. The property included as marital property is either owned individually or co-owned for purposes of taxation. 1982 *P-H Divorce Taxation* ¶ 6206.

177. 1972 T.C.M. (P-H) ¶ 72,076, at 72-318 (March 28, 1972).
178. *Id.*
179. *Id.*
180. *Id.*
181. Woodbury v. Commissioner, 49 T.C. 180 (1967).

ranching enterprise. The Tax Court found that the son's services were about equal to those of the father, and that equal allocations for personal services had been made from the partnership income, with the remainder divided according to their capital interests. However, the court refused to find that the land used in the ranch operations had been held by the partnership. The court emphasized that title to the farmland was in the father's name and, as such, the son had no interest in the property. The court placed great weight on the fact that, under Montana law, an estate in real property can be transferred only by operation of law, or by a written instrument.[182] The court concluded by noting that the petitioners had offered no evidence of any gift of real property, other than a declaration by the parties that a gift was intended.[183] This is particularly troubling in the context of post-mortem recognition of informal partnerships, since the time to transfer title to real property has passed. However, the court appeared to recognize that if there is strong evidence from which to infer a partnership relationship, such evidence may also support the allocation of land ownership.

Finally, partnerships must also be distinguished from employment, or independent contractor, relationships. One hallmark of an employee-employer relationship is the subservience of the employee to the employer. The absence of a right to participate in overall management and control of a business or venture is of particular importance in distinguishing partners from employees or servants.[184] Finally, the key distinction between employees, agents, or independent contractors and partners is the presence or absence of substantial capital interests.[185]

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182. *Id.* at 194.

183. *Id.*

184. *See, e.g.*, James v. Commissioner, 16 T.C. 930 (1951), *aff'd per curiam*, 197 F.2d 813 (5th Cir. 1952).

185. *See, e.g.*, Estate of Smith v. Commissioner, 313 F.2d 724 (8th Cir. 1963); Loveland v. Commissioner, 13 T.C. 5 (1949). Another of the most common and perplexing questions that arises in the tax classification of business arrangements is whether the co-ownership of property constitutes a partnership. Nelson, *supra* note 7, at § 15.01. For purposes of distinguishing mere co-ownership from partnership, the Regulation emphasizes the level and extent of joint activity of the co-owners with respect to the property. Treas. Reg. § 1.761-1(a) (1972). Thus, the Regulation states that the mere co-ownership and rental of property is not a partnership, even though the co-tenants jointly maintain, keep in repair, and rent or lease the property. *Id.* On the other hand, the Regulation states that a partnership exists if co-owners of an apartment building lease space and, in addition, provide services to lessees, either directly or through an agent. *Id.* Rev. Rul. 75-374, 1975-2 C.B. 261, indicates that the level of joint activity required to convert mere co-owners into partners may be significantly greater than joint maintenance and net leasing. It held that co-owners of an apartment project were not partners, even though, through an agent, they actively leased apartment units and provided "cus-

IV. CONCLUSION

Somewhat like the tort-feasor who must take the plaintiff with the eggshell skull,[186] the post-mortem estate planner takes the decedent's estate plan as it lies. In addition to the more traditional methods of post-mortem estate planning,[187] there is an opportunity, and a duty, both to the client and the government fisc, to properly reflect the decedent's interest in the final estate tax return. The careful planner may be able to include or exclude property from the gross estate by the recognition of informal family farm partnerships. However, this method of altering estate contents is difficult at best, and perilous at worst, since the definition of a partnership for tax purposes is both broad and imprecise.

Thomas Earl Geu '83

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tomary tenant services" to the lessees. *Id.* This question, however, is not as important in the context of post-mortem planning because, if co-ownership of property can be established without using the informal partnership theory, there is no need to prove that an informal partnership exists.

186. In tort law, if the plaintiff suffers any foreseeable impact or injury, even if relatively minor, the defendant is generally held liable for any additional unforeseen physical consequences. This principle is illustrated by the hypothetical case of a plaintiff who, unbeknownst to the defendant, has a skull of eggshell thickness. If the defendant negligently inflicts a minor impact on this skull, but because of this hidden defect the plaintiff dies, the defendant will be liable for his death. W. PROSSER, LAW OF TORTS 262 (4th ed. 1971). The rule is sometimes expressed by saying that the defendant takes his plaintiff as he finds him. Watson v. Rinderknecht, 84 N.W. 798 (Minn. 1901).

187. *See supra* notes 1-3 and accompanying text.