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FAMILY PARTNERSHIPS: WHO MUST RECOGNIZE THE TAXABLE INCOME?

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The partnership is often employed as the organizational structure for conducting family business. As a tax conduit,[1] it escapes taxation at the entity level, and has great utility and flexibility for the allocation of business income and losses. Such attributes serve to make the partnership well suited to accommodate the often complex business dealings among family members.

The partnership business organizational form is appealing to the family, also, because of its utility as an income-splitting device. Often a wealthy family unit can reduce its aggregate tax liability by transferring income-producing property to a family partnership and giving partnership interests to family members. Properly structured, such transactions can shift income from higher to lower bracket taxpayers, effectively reducing income tax liability but not the income level of the economic unit.[2] For the most part, this is a legally sanctioned means of tax avoidance.[3]

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1. A tax conduit is an entity that is not subject to income taxation. Its income is attributed to its owner who, in turn, pays the income tax. Partnership income is attributed to its partners, generally, in proportion to their ownership interest in the partnership and included in their gross income for tax purposes. Thus, the entity serves as a "conduit" through which income flows and is not a taxpayer itself. Other entities which to some extent are tax conduits include subchapter S corporations, trusts, estates, regulated investment companies, real estate investment trusts, insurance companies and farm cooperatives.

2. See A. ARONSOHN, PARTNERSHIPS AND INCOME TAXES (1970); J. PENNELL & J. O'BYRNE, FEDERAL INCOME TAXATION OF PARTNERS AND PARTNERSHIPS 270-84 (1970); Beck, *Use of the Family Partnership as Our Operating Device—The New Regulations*, 12 N.Y.U. INST. FED. TAX. 603 (1954); Landis, *Utility and Effect of the Partnership in Family Planning*, 24 N.Y.U. INST. FED. TAX. 339 (1966); Rothernburg, *Minors in Family Partnerships Since 1954*, 46 TAXES 17 (1968); Thorson, *Analysis of the Sources of Continued Controversy over the Treatment of Family Income*, 18 NAT'L TAX J. 113 (1965); Note, *Income Splitting as a Means of Avoiding Taxes*, 19 VAND. L. REV. 1289 (1966); Comment, *Family Partnerships and the Revenue Act of 1951*, 61 YALE L.J. 541 (1952), for discussion of the principles and techniques related to income splitting.

3. Stanback v. Commissioner, 271 F.2d 514 (4th Cir. 1959); Neil v. Commissioner, 269 F.2d 563 (5th Cir. 1959); Finlen v. Healy, 187 F. Supp. 434 (D. Mont. 1960); Leo A. Woodbury, 49 T.C. 180 (1967); Jack Smith, 32 T.C. 1261 (1959); C. Turner, 24 TAX. CT. MEM. DEC. (CCH) 544, (1965); J. O'Donnell, Jr., 23 TAX CT. MEM. DEC. (CCH) 210 (1964); I.R.C. § 704(e) and accompanying Treasury Regulations.

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Substance and not merely the form of such transactions will determine the ownership of interests in family partnerships.[4] Income from such property will be attributed to the taxpayer who actually owns it.[5] Income may be split only by shifting the ownership of the underlying income producing property.[6] The principle of progressivity so firmly established in our income tax system, would be severely frustrated if partnerships could freely be employed as income splitting devices.

It therefore becomes necessary to establish rules designed to distinguish legitimate family partnership arrangements from sham transactions that manifest unacceptable tax avoidance objectives. Gratuitous transfers of interests in family partnerships will often have bona fide objectives and the law should not be construed so as to discourage their occurrance. However, the federal fisc must be protected from imaginative income-splitting efforts involving family partnerships.

Section 704(e) of the Internal Revenue Code, enacted in 1951, represents Congress' effort to balance the competing interests in this area. Generally, its rules provide that a person will be recognized as a partner for federal income tax purposes if he owns a capital interest[7] in a partnership in which capital is a material income-producing factor.[8] It does not matter whether such interest was acquired by purchase or by gift.[9]

Generally, these provisions establish a non-exclusive safe harbor for taxpayers who seek recognition as a partner for federal income tax purposes.[10] This safe harbor is non-exclusive because it only provides protection for taxpayers who own interests in partnerships in which capital is a material income-producing factor.[11] However, non-compliance with the conditions found in section 704(e)(1) does not conclusively establish that partnership status will not be recognized.

I. AN OVERVIEW OF THE PROVISIONS UNDER SECTION 704(e).

Section 704(e) codifies several case law principles designed to limit income splitting for tax avoidance purposes. Section 704(e) reflects the prin-

4. Treas. Reg. § 1.704-1(e)(2)(i) (1976).
5. Treas. Reg. § 1.704-1(e)(1)(i) (1976).
6. *Id.*
7. Treas. Reg. § 1.704-1(e)(1)(v) (1976) defines "capital interest" for these purposes as an interest in the assets of a partnership, which is distributable to its owner upon his withdrawl from the partnership or upon its liquidation. A mere right to participate in the partership profits alone is not a capital interest.
8. Under Treas. Reg. § 1.704-1(e)(1)(iv) (1976), capital is a material income-producing factor if a substantial portion of a partnership's income is attributable to the employment of capital in its business. Manufacturing or real estate businesses usually meet this materiality requirement, where personal services businesses do not. Whether capital is a material income-producing factor is determined by reference to all the facts and circumstances of each case.
9. I.R.C. § 704(e)(1).
10. *See* W. MCKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 14.02 (1977).
11. I.R.C. § 704(e)(1).

ciple that personal service income is taxable to the person who earns it.[12] Generally, it provides that the distributive share of the partner who received his interest gratuitously shall not include income attributable to services rendered to the partnership by his donor.[13]

In most cases, income derived from the ownership of income-producing property is attributed, for tax purposes, to the owner of such property.[14] This principle is codified under present law which provides that a partner who receives his interest gratuitously cannot receive a distributive share of partnership income that exceeds the amount attributable to his donor's *capital* contribution.[15] Generally, the donee in such situations will own only the capital represented by the partnership interest he gratuitously received. He can receive only that portion of partnership income attributable to the interest he now owns.

Section 704(e)(1) codifies the case law rule that income can effectively be shifted only when the underlying capital interest that produced it has been effectively transferred.[16] This capital-income or tree-fruit analysis[17] effectively prohibits the attribution of capital income to anyone other than the owner of the underlying capital interest. However, section 704(e)(1) clearly intends that a donor will not have attributed to him income from capital if such income accrued subsequent to an effective transfer of his ownership interest in the underlying capital asset.

With the enactment of section 704(e) in 1951, Congress abolished the so-called "original capital" requirement of prior law for partnerships where capital is a material income-producing factor.[18] Additionally, Congress intended that taxpayers who successfully negotiated their way into this non-exclusive safe harbor would not have their status as partners denied solely because they had tax avoidance as a motive.[19]

Although section 704(e) does not apply to partnerships in which capital is not a material income-producing factor, where the section does

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12. Lucas v. Earl, 281 U.S. 111 (1930).
13. I.R.C. § 704(e)(2).
14. Blair v. Commissioner, 300 U.S. 5 (1937); Eisner v. Macomber, 252 U.S. 189 (1920).
15. I.R.C. § 704(e)(2).
16. *See* note 14 and accompanying text *supra*.
17. Eisner v. Macomber, 252 U.S. 189 (1920).
18. During the 1940's many courts refused to recognize family members as partners if their partnership interests were derived by gift from other family members. Theirs was not "original capital." Case law (Culbertson v. United States, 337 U.S. 733 (1949)) and later statute (I.R.C. § 704(e)) abolished this partner-recognition requirement for it did not respect the principle that income from property is attributable to such property. *See* W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 10, ¶ 14.01[1].
19. Treas. Reg. § 1.704-1(e)(2)(x) (1976). However, the presence or absence of a tax-avoidance motive is one of many factors to be considered in determining the reality of the ownership of a capital interest acquired by gift.

apply it attributes partnership status to anyone who complies with its conditions, regardless of family relationship or the absence thereof.[20]

A taxpayer will be recognized as a partner, for federal income tax purposes, if two requirements are met. They include:

(1) he must own a capital interest in a partnership, and
(2) such partnership must be one in which capital is a material income producing factor.

Where these requirements are met there should be less reliance upon or significance given to the subjective intent of the donor or donee involved in the gratuitous transfer of a partnership interest.[21] This represents a considerable qualification of prior law,[22] which remains viable for partnerships in which capital is not a material income-producing factor.

Satisfaction of the materiality and ownership requirements of section 704(e) has not resulted in partner recognition to the extent intended by Congress. The Internal Revenue Service and the courts, in efforts to prevent tax avoidance, have simply refused to allow section 704(e) to operate as a safe harbor. These tribunals have made the law impotent by administrative and judicial fiat. By intentionally exceeding lawful endeavor they have undermined section 704(e), frustrated legislative intent, and created a trap for the unwary. Legislated mandate should prevail over inconsistent judicial or administrative efforts, particularly where the consequence of such inconsistent efforts is a quagmire of uncertainty. Congress should act to remove such unauthorized and unwarranted deterrents to partnership transactions and lend certainty to the partner recognition question.

A. *The Material Income-Producing Factor Requirement*

This requirement provides that partner recognition will not be allowed, for federal income tax purposes, by operation of section 704(e) unless a substantial portion of the partnership's gross income was attributable to the employment of capital in the business.[23] Generally, partnerships engaged in personal services businesses will not meet this requirement.[24] However, such a partnership may meet this requirement if a substantial portion of its gross income is attributable to the financing of accounts receivable or contracts, or to the partnership's acquisition of good will.[25]

20. Although I.R.C. § 704(e) bears the heading "Family Partnerships" the partner-recognition rule of I.R.C. § 704(e)(1) applies to an interest received by purchase or gift from "any other person." *See* W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 10, at ¶ 14.01[5].

21. *See* Evans v. Commissioner, 447 F.2d 547 (7th Cir. 1971); W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 10, at ¶ 14.02[3].

22. Culbertson v. Commissioner, 337 U.S. 733 (1949).

23. I.R.C. § 704(e)(1); Treas. Reg. § 1.704-1(e)(l)(ii) (1976).

24. Treas. Reg. § 1.704-1(e)(1)(iv) (1976).

25. *Id.*

This materiality requirement reflects Congress' intent that partnership income be treated in accordance with several fundamental principles of federal income taxation, including:

(1) income from personal services is attributable to the person who rendered the personal services; and
(2) income from property is attributable to the owner of such property.[26]

Where capital is not a material income-producing factor in a partnership's business, income derived from the business is generated from personal services, rather than from property, and should be attributed to those who performed the personal services.[27] This result will not be avoided by conducting a personal services business in partnership form and giving partnership interests and income to persons other than those who performed the services. Such income-assignment attempts are not effective to shift the recognition of income from those who in fact earned it.[28] However, where capital is a material income-producing factor, each partner, as an owner of an interest in the capital, has a right to the part of such partnership income which that capital produces.[29]

A close analysis of two cases, *Ketter v. Commissioner*[30] and *Carriage Square, Inc. v. Commissioner,*[31] both decided recently, will serve to illustrate the parameters of this materiality condition precedent to partner recognition under the non-exclusive safe harbor provision of section 704(e). Such analysis will also indicate the extent to which the Internal Revenue Service and the courts have gone to frustrate congressional intent in this area.

First, consider the case of *Ketter v. Commissioner,*[32] in which the taxpayer had conducted an accounting practice as a sole proprietorship for several years. He ultimately employed sixteen persons in his business. In 1968, the taxpayer created eight irrevocable trusts. The taxpayer's six minor children were each made a beneficiary of one of the eight trusts, with St. Benedict's College made beneficiary of the other two. The taxpayer's brother-in-law was the initial trustee of all eight trusts. A local bank was designated successor trustee for the first six trusts and the taxpayer's eldest living child above age twenty-one was designated successor co-trustee with the bank for the other two trusts.

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26. S. REP. NO. 781, 82nd Cong., 1st Sess. 38, 39; H.R. REP. NO. 586, 82nd Cong., 1st Sess. 32 (1951). *See also* W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 10, at ¶ 14.01[2].
27. Lucas v. Earl, 281 U.S. 111 (1930).
28. Poggetto v. United States, 306 F.2d 76 (9th Cir. 1962); Ketter v. Commissioner, 70 T.C. 637 (1978).
29. I.R.C. § 704(e)(1); Treas. Reg. § 1.704-1(e)(1)(ii) (1976). *See* cases cited note 3 *supra*.
30. 70 T.C. 637 (1978).
31. 69 T.C. 119 (1977).
32. 70 T.C. 637 (1978).

The indentures for the six trusts created for the benefit of the taxpayer's children precluded the taxpayer from borrowing money from the trusts, directly or indirectly, without adequate interest or security. Sole control over these trusts was vested in the trustee, who had broad powers, including the authority to form a partnership to provide certain services to certified public accountants. Trust income was payable to its beneficiary for life, after reaching age twenty-one, or could be accumulated at the beneficiary's election. No trust income could be used in any way to satisfy the taxpayer's obligation to support his minor children. Other provisions related to these trusts and those created for the benefit of St. Benedict's College, not relevant here, were made by trust indenture.

Each trust was assigned an undivided one-eighth interest in a portion of the "work in progress" of the taxpayer's existing accounting firm and the employment contracts held by him with employees in his firm. These transfers were valid under state law.

On the same day the trusts were created, the trustee formed a partnership among the eight trusts which bore the taxpayer's name, although the taxpayer was not a partner. The "work in progress" and the employment contracts, which had been assigned to the trusts, were reassigned to the newly formed partnership. The partnership agreement, valid under state law, gave each partner equal management rights.

On the same day the trusts and the partnership were created, the partnership contracted with the taxpayer, as independent contractor, to provide him certain accounting services. The taxpayer agreed to pay the partnership seventy-three percent of the standard billing rate for services it performed. This agreement also provided that the taxpayer would provide the partnership with services for which he would be compensated on a reasonable time and expense basis.

The partnership began operations with sixteen employees and expanded to thirty over several years. Its billing practice and overhead necessitated borrowing working capital from time to time. The trustee devoted approximately fourteen hours per year to the trust's partnership business for which he received as compensation between fifty and seventy-five dollars annually.

The Commissioner refused to recognize the partnership for income tax purposes, attributed the partnership income to the taxpayer, and assessed a deficiency in his federal income tax. The tax court upheld the Commissioner's action and resolved that the partnership, composed of eight trusts established by a taxpayer for the benefit of his six minor children and his alma mater, would not be recognized for federal income tax purposes under section 704(e).[33]

The court observed that section 704(e)(1) imposes two requirements for recognition as a partner: (1) the partnership must be one in which

33. *Id.* at 651.

capital is a "material income-producing factor," and (2) the person must "own" the partnership interest.[34] The court concluded, after considering all facts and circumstances,[35] that neither requirement was met.[36]

With respect to the materiality requirement, the court after discussing applicable statutes, case law, and regulations, turned to the relevant facts. Virtually all of the partnership income constituted compensation for services rendered by partnership employees. The partnership maintained no inventory. Relative to its income level the partnership owned very little equipment. The taxpayer's reputation brought in the partnership's business. Such facts do not suggest that this partnership was one in which capital was a material income-producing factor. The *Ketter* court concluded that the "work in progress" did not constitute a material income-producing factor.[37] Neither did the employee contracts[38] nor the necessity to borrow capital satisfy the materiality requirement.[39] The court acknowledged that such capital items may be sufficient to satisfy the materiality requirements for partnerships engaged in the distribution, sale and merchandising of products in the ordinary course of business.[40] However, such partnerships were considered appreciably different in kind from "personal service partnerships."[41]

The court resolved that "it was neither the employment contracts, nor the work in progress, nor the small amount of equipment which enabled the partnership to produce income."[42] Its income depended upon the taxpayer. Consequently, capital was not a material income-producing factor.[43]

While *Ketter* is arguably sound in its resolution of the materiality question, its application to the income-assignment principle raises serious questions. Does *Ketter* suggest that a professional services partnership must always allocate income to its earner? What about the bright young lawyer or accountant who generates more income from his services than he is paid by his partnership? May the partners attribute such income to him for federal income tax purposes? Does *Ketter* support an employee action for earned but unpaid income? Does ownership of an interest in a personal services partnership no longer ensure the owner a share of partnership pro-

34. *Id.* at 643-44.
35. This is required by Treas. Reg. § 1.704-1(e)(1), (2) (1976). *See* Ballou v. United States, 370 F.2d 659 (6th Cir. 1966), *cert. denied*, 388 U.S. 911 (1967); Pflugradt v. United States, 310 F.2d 412 (7th Cir. 1962); Acuff v. Commissioner, 35 T.C. 162 (1960), *aff'd per curiam*, 296 F.2d 725 (6th Cir. 1961).
36. 70 T.C. 637, 651 (1978).
37. *Id.* at 646.
38. *Id.* at 647.
39. *Id.* at 645.
40. *Id.* at 646.
41. *Id.*
42. *Id.* at 647.
43. *Id.*

fits? Will *Ketter* subject the salary level of partnership employees to increasing judicial scrutiny? To my mind, these are legitimate questions in light of *Ketter*.

That practical reality has been eschewed for conceptual nicety was more boldly illustrated in the case of *Carriage Square, Inc. v. Commissioner*.[44] In *Carriage Square*, the taxpayer was a corporation. The taxpayer and its principal owner, Condiotti, were both in the real estate development business. Condiotti gave $5,000 to his mother. On February 14, 1969, Condiotti's mother established five trusts, one each for the benefit of Condiotti, his wife, and his three minor children, using $1,000 of the gift money as the corpus of each trust.

Barlow, Condiotti's tax adviser and owner of the remaining shares of the taxpayer corporation, was named trustee of each trust. On the same day they were established, the trusts, as limited partners, and the taxpayer, as general partner, entered into a limited partnership agreement. The purpose of the partnership was to acquire and develop residential property and to do such business under the name of Sonoma Development Company. The taxpayer contributed $556 of its capital and each trust contributed its $1,000. Each trust received an eighteen percent interest in Sonoma and the taxpayer received a ten-percent interest. The trusts were not obliged to contribute any additional capital to Sonoma and, as limited partners, each trust's liability was limited to its capital contribution.[45] As general partner, the taxpayer's liability was unlimited.[46]

From its establishment, Sonoma had the ability to borrow from a bank all of the money necessary to finance a real estate development and construction project. By employing borrowed capital, Sonoma profitably engaged in the business of having homes built and sold. Condiotti and his wife gave a continuing guarantee for several Sonoma construction loans.[47]

Sonoma's income for the three years in question in *Carriage Square* was allocated at a rate of eighteen percent to each of the five trusts for an aggregate figure of ninety percent, and ten percent to the taxpayer. The Commissioner allocated all of Sonoma's income for this period to the taxpayer and assessed a deficiency.[48]

The Commissioner's action was based upon his determination that Sonoma's income was earned solely by the services performed and the financial risks assumed by the taxpayer.[49] The court in *Carriage Square* concluded that capital was not a material income-producing factor in Sonoma's business.[50]

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44. 69 T.C. 119 (1977).
45. UNIFORM LIMITED PARTNERSHIP ACT § 7.
46. *Id.* § 9.
47. 69 T.C. 119, 123 (1977).
48. *Id.* at 124.
49. *Id.* at 126.
50. *Id.* at 127.

The court noted that Sonoma's initial capital contribution was $5,556, and that it earned $322,942 during its first three years. Further, the court conceded that borrowed capital may be "capital" for section 704(e)(1) purposes, but held that it was not in this case.[51]

The court observed that the taxpayer, as Sonoma's only general partner, was the only partner in Sonoma whose liability for repayment of such borrowed capital was not substantially limited.[52] Perhaps it escaped the court's attention that this is true in any limited partnership that has one general partner.[53]

The court also noted that Sonoma would have been unable to secure the borrowed capital it employed in its real estate business without the continuing guarantee executed by Condiotti.[54] Apparently, Condiotti's behavior was imputed to the taxpayer by the court. It could have been as soundly imputed to the trust established for Condiotti's benefit or to him personally. It would seem consistent with a general partner's duty to its limited partnership for it to secure needed capital on mutually agreeable terms from whatever sources available. Nothing inherent in such conduct would preclude a finding that capital was a material income-producing factor in the partnership business.[55]

Finally, the court reasoned that "[s]ince Sonoma made a large profit with a very small capital contribution from its partners, and was able to borrow, and did borrow, substantially all of the capital which it employed in its business upon the condition that such loans were guaranteed by nonpartners," section 1.704-1(e)(1)(i) of the income tax regulations prohibits the borrowed capital involved in *Carriage Square* from being considered as a "material income-producing factor."[56] The regulations require such capital to be "contributed by the partners."[57]

It is interesting to note that no such qualifying language can be found in section 704(e) itself. A literal reading of its provisions in no way supports the Service's regulation requirement, or the court's reliance upon it to find that capital was not a material income-producing factor in Sonoma's business.[58]

A concurring opinion in *Carriage Square,* adopted by six judges, while generally agreeing with the result, did not agree with the majority's conclusion that borrowed capital was not a material income-producing factor

51. *Id.*
52. *Id.*
53. *See* notes 45 & 46 and accompanying text *supra.*
54. Carriage Square, Inc. v. Commissioner, 69 T.C. 119, 127 (1977).
55. Treas. Reg. § 1.704-1(e)(1)(iv) (1976).
56. Carriage Square, Inc. v. Commissioner, 69 T.C. 119, 127 (1977).
57. Treas. Reg. § 1.704-1(e)(1)(i) (1976).
58. I.R.C. § 704(e)(1); Treas. Reg. § 1.704-1(e)(1)(ii), (iv) (1976). *See also* note 18 and accompanying text *supra.*

in the Sonoma limited partnership.[59] Additionally, it opined that the majority opinion was "out of touch with reality"[60] and observed that borrowed capital is invariably employed in real estate developments.[61] Moreover, this same opinion observed that the rationale adopted by the majority was "gratuitous," not being presented by the Commissioner nor argued by either party.[62] It characterized the majority's emphasis upon the unlimited liability of the general partner (taxpayer) as distinguished from the limited liability of the limited partners (trust) as a meaningless distinction[63] and its approach to the tax avoidance problem as "strained."[64] The concurring opinion reasoned for "an alternative which is less dangerous, supported completely by the regulations and in harmony with the Congressional intent of section 704(e)."[65]

A partially dissenting opinion which carried five judges in *Carriage Square* declared that "capital was clearly a material income-producing factor in the business of Sonoma . . . ."[66] Whether such capital was contributed by the partners or borrowed by the partnership is not relevant to this determination.[67] What does matter is the function served by capital (from whatever source) employed in the business conducted by the partnership.[68]

A second dissenting opinion concluded that the majority's approach "does violence to the previously well-understood meaning of 'capital as a material income-producing factor.'"[69] It viewed the notion that borrowed capital should not be considered in determining whether capital is a material income-producing factor as a "hitherto-undreamed-of principle,"[70] and counseled against "trying to make statutory phrases do more than they were designed for."[71]

At least one reaction to the *Carriage Square* decision has been forceful and direct.[72] Administrative or judicial sensitivity towards the use of the family partnership as an income splitting device and tax avoidance in this area is understandable. However, improper legislating by these tribunals is not, particularly where it frustrates congressional intent.

59. Carriage Square, Inc. v. Commissioner, 69 T.C. 119, 130 (1977) (Goffe, J., concurring).
60. *Id.*
61. *Id.*
62. *Id.*
63. *Id.*
64. *Id.* at 131.
65. *Id.*
66. *Id.* at 139, 141 (Tannenwald, J., dissenting in part).
67. *Id.*
68. *Id.*
69. *Id.* at 141, 142 (Hall, J., dissenting).
70. *Id.* at 142.
71. *Id.*
72. *See* Blount, *Carriage Square, Inc. v. Commissioner: Family Partnership, Section 704(e) and Judicial Legislation*, 14 GA. ST. BAR J. 179 (1978).

The court's action in *Carriage Square* is unfortunate for practical reasons. Sonoma was engaged in the real estate business. The real estate industry has traditionally enjoyed preferred treatment in the Internal Revenue Code.[73] *Carriage Square,* if allowed to stand, will frustrate federal policy and law designed to facilitate capital formation in this area.[74] The real estate industry, in all its aspects, relies extensively upon borrowed capital in its operations. Thus, capital is invariably a material income-producing factor in the real estate business. Against these considerations, as suggested earlier, the *Carriage Square* decision is "out of touch with reality."[75]

Carriage Square judicially legislates an "at-risk" rule for limited partners in family partnerships in which capital is a material income-producing factor. It was of no significance to this court that a limited partner, by definition, enjoys limited liability. Further, it did not matter that capital contributed to a partnership is often insufficient to meet business needs or that borrowing needed working capital is a highly developed propensity of the business community. To hold that borrowed money does not constitute capital when a real estate partnership is concerned constitutes self-deception or a rejection of reality. Lastly, it should be noted that the majority's feeble attempt to limit its holding to the facts of the case is not compelling.[76]

B. *The Capital Interest Ownership Requirement*

Section 704(e)(1) requires the ownership of a capital interest in a partnership in which capital is a material income-producing factor before a taxpayer will be recognized as a partner. "Capital interest" as employed in section 704(e)(1) means "an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawl from the partnership or upon liquidation of the partnership."[77] The mere right to participate in partnership earnings and profits does not qualify as a capital interest. Capital interests in such partnerships must be acquired in valid transactions, and the donee or purchaser must be the real owner of such interest.[78] A transfer will be recognized if it vests dominion and control of the partnership interest in the transferee.[79] Whether such dominion and control is vested in the trustee is a fact question to be determined after consideration of all facts and circumstances.[80] Transactions between fami-

73. *See* I.R.C. §§ 44, 48(a)(8), 121, 167(k), 191, 465, 804(c)(2), 856-860, 1250(g).
74. *Id.*
75. *See* text accompanying note 60 *supra*.
76. Carriage Square, Inc. v. Commissioner, 69 T.C. 119, 127 (1977).
77. Treas. Reg. § 1.704-1(e)(1)(v) (1976).
78. Treas. Reg. § 1.704-1(e)(1)(iii) (1976).
79. *Id.*
80. *Id.*

ly members will be closely scrutinized, and transfers will not be recognized where the transferor retains such elements of ownership that the transferee has not acquired full and complete ownership of the partnership interest.[81]

Analysis in this area requires consideration of the transaction as a whole. Isolated facts will not be determinative.[82] An analytical focal point here is the degree of control over the partnership retained by the transferor.[83] Significant controls include retention of control or restriction over distribution of income attributable to partnership interest involved,[84] limitation of the right of the transferee to liquidate or sell his interest,[85] retention of control over assets essential to the business,[86] and retention of management powers inconsistent with normal relationships among partners.[87]

Indirect control inconsistent with transferee ownership of a capital interest in a partnership may preclude partner recognition for federal income tax purposes as well.[88] Indirect control is often effectuated through separate business organizations, estates, trusts, individuals or other partnerships.[89]

Substantial transferee participation in the management and control of partnership business[90] and receipt of his distributive share of partnership income[91] constitutes strong evidence that the transferee possesses dominion and control over his capital interest and that such interest is real. The absence of participation by a limited partner in the management of a limited partnership, of course, will not preclude partner recognition.[92] If the reality of the transfer is established, the motives for the transaction are generally immaterial.[93]

Retained controls that are incidental to a business relationship between transferee and transferor may not preclude partner recognition.[94] Additionally, where retained controls are exercisable for the benefit of the transferee by the transferor acting as fiduciary, partner status may be attributed to the transferee.[95]

81. Treas. Reg. § 1.704-1(e)(2)(ii) (1976).
82. Treas. Reg. § 1.704-1(e)(2)(i) (1976).
83. Treas. Reg. § 1.704-1(e)(2)(ii) (1976).
84. Treas. Reg. § 1.704-1(e)(2)(ii)(a) (1976).
85. Treas. Reg. § 1.704-1(e)(2)(ii)(b) (1976).
86. Treas. Reg. § 1.704-1(e)(2)(ii)(c) (1976).
87. Treas. Reg. § 1.704-1(e)(2)(ii)(d) (1976).
88. Treas. Reg. § 1.704-1(e)(2)(iii) (1976).
89. *Id.*
90. Treas. Reg. § 1.704-1(e)(2)(iv) (1976).
91. Treas. Reg. § 1.704-1(e)(2)(v) (1976).
92. Treas. Reg. § 1.704-1(e)(2)(ix) (1976).
93. Treas. Reg. § 1.704-1(e)(2)(x) (1976).
94. Treas. Reg. § 1.704-1(e)(2)(ii) (d) (1976).
95. *See, e.g.*, Miller v. Commissioner, 203 F.2d 350 (6th Cir. 1953). *See also* W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 10, ¶ 14.03[2].

Several objective factors demonstrating a transferee's control of a partnership have been listed.[96] Such factors include (1) compliance with local partnership, fictitious name and business regulation statutes, (2) control of business bank accounts, (3) recognition of the transferree's rights in distributions of partnership property and profits, (4) recognition of the transferee's rights in business contracts as well as in litigation affecting the business, (5) the existence of written instruments establishing the nature of the partnership against and the respective rights of the respective partners, and (6) filing of partnership tax returns as required by law.[97]

The *Ketter* case[98] is illustrative of the current judicial attitude toward these ownership rules. In *Ketter*, the court concluded that the facts and circumstances, considered as a whole, revealed that the taxpayer there involved retained such incidents of dominion and control over the partnership that the trusts could not be recognized as owners of the partnership interests under section 704(e)(1).[99]

Factually, the trust partners in *Ketter* held legal title to their partnership interests. The taxpayer-grantor retained no reversionary interest in trust assets. He could in no way benefit from trust income or property. Each trust's distributive share of partnership profits was payable (and paid) annually. Each trust partner held the right to withdraw from the partnership or liquidate its interest therein. The partnership kept separate books and records. It maintained and solely controlled two bank accounts. Also, it filed its own tax returns. The partnership agreement, valid under state law, gave each partner (trusts included) equal management rights.[100]

Additional indicia of real ownership are difficult to imagine. However, the *Ketter* court resolved that the controls retained by the taxpayer-grantor and the manner in which the partnership's business was conducted "clearly demonstrated" that he retained actual dominion and control sufficient to preclude recognition of the trusts as partners.[101]

The court made much of the fact that the taxpayer was the principal manager of the partnership's business and that he managed the partnerships much like he had managed his sole proprietorship. However, the court failed to observe that he did so pursuant to contractual obligation,[102] or that service as fiduciary in such instances is insufficient, standing alone, to preclude partner or partnership recognition under section 704(e)(1).[103]

The court also viewed unfavorably the relatively small amount of time devoted to partnership management by the sole trustee for the several trust

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96. W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 10, at ¶ 14.03[3].
97. *Id.*
98. Ketter v. Commissioner, 70 T.C. 637, 647 (1978).
99. *Id.* at 647, 648, 651.
100. *Id.* at 638-43.
101. *Id.* at 648.
102. *Id.* at 641.
103. *See* note 95 and accompanying text *supra*.

partners.[104] However, the court did not conclude that the trustee or the trust partners breached any fiduciary duty owed to the partnership or each trust individual. Apparently, the fact that the partners were paying a proven manager to perform this function escaped judicial notice. At no time did the court suggest that the management contract between the partnership and the taxpayer was illusory, sham, or otherwise ineffectual. Lastly, it would seem that reduced trustee involvement in partnership management, standing alone, is not sufficient to preclude partner or partnership recognition here.

The *Ketter* court found that the taxpayer's independent accounting practice was a major vehicle of control over the partnership in as much as the partnership depended upon the taxpayer's business for work referrals. The court reasoned that this constituted "control over assets essential to the business,"[105] and that "the use of a separate grantor-controlled facility to regulate the flow of income to a partnership has frequently been found a significant factor leading to the non-recognition of the partnership for federal income tax purposes."[106]

The court cited three cases for this latter proposition. All three are distinguishable factually and their results are more sound conceptually than *Ketter*. The first, *Krause v. Commissioner,*[107] is significantly different factually from *Ketter* in that the taxpayer-grantor retained controls over the trusts' right to transfer their partnership interest, he could remove the trustee of each trust, and the trusts had limited durations. Additionally, the *Krause* opinion does not expressly refer to the "regulate the flow of income" concept, contrary to the court's suggestion in *Ketter*. On balance the ratonale of *Krause* does not compel the result reached in *Ketter* on the retained control question.

The second case cited by the *Ketter* court for the proposition that the taxpayer retained control of assets essential to the partnership's business is also distinguishable factually and conceptually. In *United States v. Ramos,*[108] no assets were transferred to the partnerships. Each partner took a share of income assigned to it from other business activity the taxpayer engaged. Thus, partner recognition was precluded. The distinction between this and the *Ketter* situation does not warrant articulation. A naked and gratuitous income assignment transaction will never support partner recognition.[109] *Ramos,* like *Krause,* does not compel the result reached in *Ketter* on the retained control question.

104. Ketter v. Commissioner, 70 T.C. 637, 648 (1978)
105. *Id.* at 649.
106. *Id.* (citing Treas. Reg. § 1.704-1(e)(2)(ii)(C) (1976)). *See also* Krause v. Commissioner, 497 F.2d 1109 (6th Cir. 1974), *aff'g* 57 T.C. 890 (1972); United States v. Ramos, 393 F.2d 618 (9th Cir.), *cert. denied,* 393 U.S. 983 (1968); Kuney v. Frank, 308 F.2d 719 (9th Cir. 1962).
107. 497 F.2d 1109 (6th Cir. 1974).
108. 393 F.2d 618 (9th Cir.), *cert. denied,* 393 U.S. 983 (1968).
109. Helvering v. Horst, 311 U.S. 112 (1940); Helvering v. Clifford, 309 U.S. 331 (1940); Lucas v. Earl, 281 U.S. 111 (1930); Overton v. Commissioner, 162

The last cite by the *Ketter* court on this question proves even less than the first two. In *Kuney v. Frank,*[110] the taxpayer retained complete control over trust income and the assets transferred to the trusts, could receive all trust income personally, was protected from obligation by exclupatory clauses, and retained control over the size and share of each trust's partnership interest. These facts prompted the court to reverse a jury verdict in favor of the taxpayer and hold as a matter of law that the partners would not be recognized. These facts are all directly opposite to those found in *Ketter*. The *Kuney* decision clearly does not compel the result reached by the court in *Ketter* on this issue.

The court's conclusion on this issue is not supported by law or fact. Its rationale, if extended, would suggest that a professional services partnership is impermissibly controlled by its clients, or that lawyer or doctor is controlled by client or patient. This reasoning is illustrative of the court's decision not to allow section 704(e) to operate as the non-exclusive safe harbor Congress intended. This exceeds legitimate judicial endeavor and encroaches upon legislative prerogative.

The *Ketter* court also found evidence of the taxpayer's control over the partnership by the manner in which its business affairs were conducted.[111] It observed that the general public was unaware of the partnership's existence, that partnership clients viewed partnership employees as the taxpayer's employees, that the taxpayer served as the partnership's manager, that the partnership bore the taxpayer's name, and that it failed to comply with fictitious name statute requirements.

Although publication of partner status in business dealings is significant,[112] this alone cannot justify non-recognition of partner or partnership.[113] Moreover, the facts clearly reflect that the partnership was not a mere "alter ego" of the taxpayers.[114] Lastly, all these observations made by the court failed to reflect that the partnership benefited handsomely from its employment of the taxpayer's services in its business, or to acknowledge that the taxpayer had been adequately compensated for services rendered.

On balance, the court analysis and disposition of the retained ownership question in *Ketter* was superficial and result-oriented. It manifests the court's propensity to cast the legislative net too broadly. One would think that the judiciary would exercise more self-restraint.

F.2d 155 (2d Cir. 1947); Commissioner v. Laughton, 113 F.2d 103 (9th Cir. 1040); Heim v. Fitzpatrick, 262 F.2d 887 (2d Cir. 1959); Irvine K. Furman, 45 T.C. 360 (1966), *aff'd per curiam*, 381 F.2d 22 (5th Cir. 1967); Paul A. Teschner, 38 T.C. 1003 (1962).

110. 308 F.2d 719 (9th Cir. 1962).

111. Ketter v. Commissioner, 70 T.C. 637, 649 (1978).

112. Treas. Reg. § 1.704-1(e)(2)(vi) (1976).

113. Treas. Reg. § 1.704-1(e)(2)(i) (1976) ("isolated facts are not determinative").

114. Neither was an alter ego theory suggested by the court's rationale in *Ketter*.

II. CONCLUSION

It is clear that the partnership has great facility for income splitting among family members. This has been a perennial problem for the courts and the IRS.

These tribunals have overreacted to this tax avoidance problem by its construction and application of the partner recognition rules where family partnership transactions have been involved. To navigate one's way safely into the calm waters of the safe harbor intended by Congress insures the taxpayer nothing. Many a ship securely moored at the docks of section 704(e) have been torpedoed by the IRS or the judiciary.

This frustration of congressional intent should not be allowed to continue. If the non-exclusive safe harbor provided by section 704(e) is ill-advised, Congress should make appropriate amendment to the law. It is clear that such legislating should not occur via administrative or judicial fiat.