ROUNDTABLES AND SECTION MEETINGS

HUSBAND AND WIFE OR "FAMILY" PARTNERSHIPS

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Recent years have revealed a determined and uninterrupted rise in the number of commercial enterprises conducted on a partnership basis.[1] Treasury Department figures show an increase of almost 70% over the number of partnership returns five years ago, and an increase of almost 130% over the figure ten years ago in 1934.[2] It would appear that a substantial part of this increase has resulted from the creation of partnerships between husband and wife (sometimes between husband and wife and children) for federal income tax reasons. The tax saving in such family partnerships is rather obvious, being found in the fact that the profits of the business (the main source of family income) may be divided among the members of the family (the partners), and taxed at considerably lower rates than would be the case if these profits were all lumped together in the return of the husband or father.

The reported cases involving litigation over the tax status of these family partnerships grow in number almost daily. The subject becomes of ever-increasing importance to the tax lawyer, and to the general practitioner as well, as more and more of his clients find that the use of this device for the reduction of income tax costs has its complications. Hence, the reason for this attempt to survey the subject, and to draw some practical conclusions from the cases.

FAMILY PARTNERSHIPS ESSENTIALLY VALID

First of all, let us consider briefly the essential validity of such family partnership arrangements.

In Indiana, at least, there can be no question as to the

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1. See Polisher, "Family Partnerships" (June, 1944) Taxes Magazine at 272.
2. The Internal Revenue Bureau "Quarterly Survey of Administrative and Audit Activities" shows 490,320 partnership returns filed from Jan. to Dec., 1943, compared with 453,902 for the same period of 1942; 372,796 in 1941; 290,876 in 1940; 273,361 in 1939; 214,881 in 1934.

legality of a partnership between a husband and his wife. That a married woman can engage in business as a partner with her husband has been decided affirmatively in at least two Indiana cases.[3] Nor is there anything in the Internal Revenue Code, or the various federal Revenue Acts, which invalidates such a family partnership for income tax purposes. On the contrary, the legality and effectiveness of such partnerships between husband and wife has been frequently and repeatedly recognized by writers on tax law[4] and by the courts in many cases upholding such family partnerships and taxing the income and profits to the respective partners in proportion to their respective interests in the business.[5]

Notwithstanding this general acceptance of the basic validity and propriety of partnerships between husband and wife, both in the strictly legal sense, and in the broader economic and practical view of the tax cases, many such part-

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3. Koering v. Bowman et al., 194 Ind. 433, 14 N.E. 117 (1924); Anderson v. Citizens National Bank 38 Ind. App. 190, 76 N. E. 811 (1906). But see conflict on power of married woman to enter into partnership with her husband under some state statutes, noted in 26 Am. Jur. (Husband and Wife) §247.

4 See Polisher, supra note 1; C. C. H. 1944 Fed. Tax Serv., Rewrite Bull. No. 18; 2 Mertens, "The Law of Federal Income Taxation" §18.07.

5. Humphreys v. Commissioner of Internal Revenue, 88 F. (2d) 430 (C. C. A. 2nd, 1937); Millard D. Olds v. Commissioner of Internal Revenue, 15 B. T. A. 560 (1929), affirmed 60 F. (2d) 252 (C. A. A. 6th, 1931); Alford T. Wagner v. Commissioner of Internal Revenue, 17 B. T. A. 1030 (1929); Arthur Stryker v. Commissioner of Internal Revenue, 17 B. T. A. 1033 (1929); Richard H. Oakley v. Commissioner of Internal Revenue, 24 B. T. A. 1082 (1931); Charles Tift v. Commissioner of Internal Revenue, 25 B. T. A. 986 (1932); Elizabeth M. Coombs v. Commissioner of Internal Revenue, 25 B. T. A. 1320 (1932); N. H. Hazlewood v. Commissioner of Internal Revenue, 29 B. T. A. 595 (1933); Jasper Sipes v. Commissioner of Internal Revenue, 31 B. T. A. 709 (1934); Walter M. Moyer v. Commissioner of Internal Revenue, 35 B. T. A. 1155 (1937); Clinton Davidson v. Commissioner of Internal Revenue, 43 B. T. A. 576 (1941); Justin Potter v. Commissioner of Internal Revenue, 47 B. T. A. 607 (1942); Max German, 2 T. C. 474; Sidney Nathan, Memo T. C. Opinion, May 14, 1943; E. R. Ledbetter, Memo B. T. A. opinion, April 30, 1942 Estate of Barringer, Memo B. T. A. opinion, Sept. 16, 1942; James O. Peterson, Memo T. C. opinion, Oct. 30, 1943; Robert P. Scherer, 3 T. C. ——, No. 100; J. D. Johnston, 3 T. C. ——, No. 101; Felix Zukaitis, 3 T. C. ——, No. 102; M. W. Smith, 3 T. C. ——, No. 110; Wachovia Bank (Stanback) v. Commissioner of Internal Revenue, Memo T. C. opinion, June 22, 1944; Irene McCullough, Memo T. C. opinion, July 19, 1944; Armstrong v. Commissioner of Internal Revenue, —— F. (2d) —— (C. C. A. ——, July 6, 1944), reversing 1 T. C. 1008 (1943); Hardymon v. Glenn, —— F. Supp. —— (Ky., June 28, 1944).

nerships have failed to accomplish the intended tax objectives; and the income of what was apparently a formal family partnership between the husband and wife, or between husband and wife and children, has repeatedly been taxed in full to the husband-father. In fact, the decisions and rulings rejecting such partnerships for income tax purposes are slightly more numerous than those which have upheld family partnership arrangements.[6]

These cases and rulings refusing to recognize family partnerships for income tax purposes have not questioned the basic validity of such an arrangement in and of itself, which, as noted, is clearly recognized. They have simply questioned the fact of partnership in the particular cases under consideration. The family partnership apparently has the same status as any other partnership for federal income tax purposes, where in fact and in truth a partnership exists. In those cases upholding family partnerships for income tax purposes, the courts have found on the facts that a bona fide and actual partnership existed, and that the wife and

6. Avent v. Commissioner of Internal Revenue, 76 F. (2d) 386 (C. A. A. 5th, 1935); Covington v. Commissioner of Internal Revenue, 103 F. (2d) 201 (C. A. A. 5th, 1939); Tinkoff v. Commissioner of Internal Revenue, 120 F. (2d) 564 (C. C. A. 7th, 1941); Earp v. Jones, 131 F. (2d) 292 (C. C. A. 10th, 1942), cert. den. 63 Sup. Ct. 665 (1943); Mead v. Commissioner of Internal Revenue, 131 F. (2d) 323 (C. C. A. 5th, 1942), cert. den. 63 Sup. Ct. 851 (1943); Waldburger v. Helvering, 131 F. (2d) 598 (C. C. A. 2nd, 1942); Villere v. Commissioner of Internal Revenue, 133 F. (2d) 905 (C. C. A. 5th, 1943); Schroder v. Commissioner of Internal Revenue, 134 F. (2d) 346 (C. C. A. 5th, 1943); Estate of Wickham v. Commissioner of Internal Revenue, 22 B. T. A. 1393 (1931), affirmed 65 F. (2d) 527 (C. C. A. 8th, 1933); Ed Kasch and Theodora Kasch v. Commissioner of Internal Revenue, 25 B. T. A. 284 (1932), affirmed 63 F. (2d) 466 (C. C. A. 5th, 1933); Harry C. Fisher v. Commissioner of Internal Revenue, 29 B. T. A. 1041 (1934), affirmed 74 F. (2d) 1014 (C. C. A. 2nd, 1935); Robert S. Eaton v. Commissioner of Internal Revenue, 37 B. T. A. 283 (1938), affirmed 100 F. (2d) 1013 (C. C. A. 2nd, 1939); Thomas M. McIntyre v. Commissioner of Internal Revenue, 37 B. T. A. 812 (1938); Harold G. Parker and May J. Parker, Husband and Wife v. Commissioner of Internal Revenue, 39 B. T. A. 423 (1939); Francis Doll, 2 T. C. 276; Francis E. Tower, 3 T. C. ——, No. 49; A. L. Lusthaus, 3 T. C. ——, No. 67; O. W. Lowry, 3 T. C. ——, No. 97; Frank J. Lorenz, 3 T. C. ——, No. 98; Fredeking v. Commissioner of Internal Revenue, Memo T. C. opinion, Oct. 21, 1943; Edward J. Miller, Memo T. C. opinion, March 18, 1944; R. W. Camfield, Memo T. C. opinion, Feb. 9, 1944; W. P. Sewell, Memo T. C. opinion, Feb. 7, 1944; Blalock v. Allen, —— F. Supp. ——, (Ga., July 19, 1944); M. M. Argo, 3 T. C. No. 143; Stanley Bradshaw, Memo T. C. opinion, July 31, 1944; Joseph Grant, Memo T. C. opinion, Aug. 3, 1944.

children were real partners making the same contributions to business success that a stranger to the family might make. In those cases which have rejected the family partnership, the courts have found on the facts that no bona fide and actual partnership existed, that the alleged partnership was one in form only without real existence in fact, and that the wife and children contributed nothing to the success of the business and were not real partners at all.

FAMILY PARTNERSHIP CASES ARE "FACT" CASES

In short, family partnership cases fall clearly into the category of "fact" cases; and in such cases the paramount question is always essentially the same: "Has the taxpayer really done what he professes he has done? Has he actually taken the steps on which his attempt at avoidance is based? If the steps have been taken as part of a real and not a colorable or sham transaction, the avoidance succeeds; otherwise it fails.[7] Viewed in this light, the apparently conflicting authorities on this question becomes readily reconcilable, for the conflict is not one involving differences of opinion as to the applicable law so much as differences of interpretation of the available facts.

In these husband and wife cases, it is obviously going to be hard to get at the real facts. The solidarity of the family unit is such that it is possible for the taxpayer to surrender legal title and technical dominion over the property interest while retaining the substance of enjoyment and control in fact through understandings with his wife as to her exercise of the rights allegedly transferred to her. As one author puts it, "the facts as to such bed chamber arrangements are difficult to prove or disprove."[8]

The Treasury Department, confronted with the practical difficulty of proving that the husband and wife partnership is not as real as it seems, has apparently adopted a policy of holding all such arrangements suspect, and placing on the taxpayer the burden of proving the reality and actuality of the transaction. While this procedure may offend our legal sensibilities in that it holds the taxpayer guilty until he proves his innocence, it must be admitted to possess some

7. See Paul, "Studies in Federal Taxation" (1st ed. 1937) 130, for a discussion of "fact" avoidance cases.

8. Id. at 151.

merit when we consider that in more than half the cases here reviewed, the family partnership WAS found to be unreal and non-existent in fact.

In determining the relative strength or weakness of a given partnership case situation it clearly becomes much more important to know the facts that the courts have accepted as significant and indicative than it is to know the relatively well-established law. An analysis of those facts is the purpose of this survey.

EFFECT OF TAX AVOIDANCE MOTIVE

At the outset, it may be noted that the mere desire to avoid, or rather to reduce, income tax costs is *not* an indicia of invalidity. The legal right of the taxpayer to reduce his taxes or avoid them entirely by legal and proper procedures is well established. The question is not what motivated the transaction, but "whether the transaction under scrutiny is in fact what it appears to be in form . . . "[9]

Nevertheless, the existence and presence of the tax motive may well have an indirect effect in its influence on the thinking of the court and its interpretation of OTHER facts in the case. In at least one case, where the inclusion of children in the partnership was motivated by a desire to build personal estates for the children, the lack of evidence as to any tax motive in the transaction was noted by the court, and apparently led to a more liberal and favorable view of certain other facts which might otherwise have proved damaging.[10] In other cases, the fact that the transaction was motivated primarily by the desire to avoid taxes, and served no other useful business purpose whatever, has likewise been noted specifically by the court, and mentioned in both the findings of fact and the opinion handed down by the majority of the court. In none of these cases did the court rely on the tax motive alone in rejecting the family partnership; but the presence of that motive rather obviously influenced the majority of the court

9. See Gregory v. Helvering, 293 U. S. 465 (1935). The above quoted phrase appears in Chisholm v. Commissioner of Internal Revenue, 79 F. (2d) 14, 15 (C. C. A. 2nd, 1935), cert. den. 296 U. S. 641 (1935).

10. Justin Potter v. Commissioner of Internal Revenue, 47 B. T. A. 607 (1942). See J. D. Johnston, 3 T. C. ——, No. 101, where it was noted that there was no evidence of any tax motive.

in its views as to the relative significance of certain various OTHER facts in the case.[11]

Motive, then, is not controlling, and is important only in that a clearly evasive transaction may be viewed with much more suspicion than one which is clearly motivated by genuine family and business reasons. In the final analysis, it is the fact of partnership, and not the reason for it, which is the issue of supreme significance.

THE BASIC INDICIA OF PARTNERSHIP

What, then, are some of the indicia of actual partnership? "In the typical contract of partnership the parties expressly agree to unite their property and services as co-proprietors to carry on a business for a profit, and to share in the profits and losses in stated proportions." Such is the general rule of law as stated in a leading text.[12] Nor is the tax rule much different. It may be emphasized that the typical REAL partnership involves a unity or merger of property or services or both. And it is noteworthy that in every husband and wife partnership which has been upheld, the wife has been found to have contributed either capital, or services, or both.

Clearly, then, such a contribution to the partnership either in capital or in personal services and labor is a primary requisite to a bona fide family partnership that will "hold water" tax-wise. If the facts reveal no such contribution of either type the alleged partnership fails to be proved, and becomes merely a device for the division of income.

This point is illustrated with great clarity by the well-recognized line of cases holding that a husband engaged in the professional and "personal service" type of enterprise (where capital is unimportant and the only tangible contribution his wife could make would be in the form of personal service and labor) can not ordinarily create an effective family partnership with his wife. In such cases, where the wife performs no services whatever, and the husband continues to operate the business, capital being unimportant, and business earnings are largely if not entirely dependent on his

11. See Earp v. Jones, 131 F. (2d) 292 (C. C. A. 10th, 1942); O. W. Lowry, 3 T. C. ——, No. 97; Frank J. Lorenz, 3 T. C. ——, No. 98.
12. 40 Am. Jur. (Partnership) §32.

personal activities, the alleged family partnership is consistently rejected as unreal and non-existent.[13]

Of course, where capital is an important factor, and was contributed by the wife from her own funds, a husband and wife partnership MAY be upheld even in such enterprises.[14]

CONTRIBUTIONS IN THE FORM OF SERVICES

What kind of services will sufficie to constitute a bona fide contribution to the partnership?

Bookkeeping and clerical duties rendered by a mother, who was in partnership with her son, when she devoted "considerable time" to the work, were noted in one case.[15] In this same case, the mother later retired as partner, and the son took his wife into the firm in her place, and the partnership was upheld, the wife contributing some capital from her independent funds, and also doing "clerical work, typing, and billing." In another case, wives who also contributed capital from independent funds were properly included as partners, especially since they also "acted as principals in the employment of the firm's staff."[16]

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13. See Schroder v. Commissioner of Internal Revenue, 143 F. (2d) 346 (C. C. A. 5th, 1943), involving an engineering business; Earp v. Jones, 131 F. (2d) 292 (C. C. A. 10th, 1942), and Edward J. Miller, Memo T. C. opinion, March 18, 1944, both involving insurance agencies; Thomas M. McIntyre v. Commissioner of Internal Revneue, 37 B. T. A. 812 (1938), and Tinkoff v. Commissioner of Internal Revenue, 120 F. (2d) 564 (C. C. A. 7th, 1941), both involving public accountant firms; Fredeking v. Commissioner of Internal Revenue, Memo T. C. opinion, Oct. 21, 1943, involving a Standard Oil agency contract; Francis Doll, 2 T. C. 276, involving the sale of shoes on a commission basis; Waldburger v. Helvering, 131 F. (2d) 598 (C. C. A. 2nd, 1942), involving the sale of textiles on a commission basis; Robert S. Eaton v. Commissioner of Internal Revenue, 37 B. T. A. 283 (1938), and Harold G. Parker v. Commissioner of Internal Revenue, 39 B. T. A. 423 (1939), both involving the sale of securities; Harry C. Fisher v. Commissioner of Internal Revenue, 29 B. T. A. 1041 (1934), involving the syndicated "Mutt and Jeff" cartoon series, where the attempt to include Bud Fisher's father and mother as partners failed, since they contributed neither capital nor labor; M. M. Argo, 3 T. C. ——, No. 143, involving a taxpayer engaged in the repairing and rebuilding of electrical machinery.
14. See Clinton Davidson v. Commissioner of Internal Revenue, 43 B. T. A. 576 (1941), involving an insurance business; Humphreys v. Commissioner of Internal Revenue, 88 F. (2d) 430 (C. C. A. 2nd, 1937 involving an accounting firm, the wives also contributing services.
15. Arthur Stryker v. Commissioner of Internal Revenue, 17 B. T. A. 1033 (1929).
16. Humphreys v. Commissioner of Internal Revenue, 88 F. (2d) 430 (C. C. A. 2nd, 1937).

Another husband and wife partnership was upheld where the wife's capital contributions were nominal, but where it was shown that "for several prior years (she) had completed management of the office and performed various duties" in her husband's beer business. It appeared that he was out of the office on sales and delivery calls most of the time, and she "waited on customers, looked after correspondence, . . . checked trucks in and out, and took care of other details," and so on, even hiring and firing employees and holding "pep" meetings for the salesmen and drivers.[17] Perhaps, the classic case of service contributions by the wife is that of Max German.[18] Rose German, his wife, daily looked after their fruit and vegetable store, while he ran the delacatessen while she continued to operate the old store. Still later, she baked and boiled hams which the husband sold and distributed.

So much for illustrative examples of real contributions to the partnership on a service basis. In passing, it may be noted that mere "wifely interest in the husband's business as demonstration by taking telephone calls at home" is NOT enough to constitute a service contribution.[19]

CONTRIBUTIONS IN THE FORM OF CAPITAL

What kind of capital contributions will suffice to indicate the existence of a bona fide and real partnership between husband and wife, either in the absence of service contributions or supplementing them?

Obviously, where the wife makes an outright capital investment in the business with her own independent funds, her claim to bona fide status as a partner is very strong indeed. Where the funds she puts into the business were clearly derived from sources other than her husband, and assuming always that capital is important to business success, there can be little question as to the reality of the partnership.[20]

17. Felix Zukaitis, 3 T. C. ——, No. 102.
18. Max German, 2 T. C. 474.
19. Frank J. Lorenz, 3 T. C. ——, No. 98.
20. See, for instance, Humphreys v. Commissioner of Internal Revenue, 88 F. (2d) 430 (C. C. A. 2nd, 1937); Estate of Barringer, Memo B. T. A. opinion, Sept. 16, 1942, where part of the wife's interest was acquired by purchase; Arthur Stryker v. Commissioner of Internal Revenue, 17 B. T. A. 1033 (1929), where the wife obtained the money from her father; Charles Tift v. Commissioner of Internal Revenue, 25 B. T. A. 986 (1932) where

In one case, the wife purchased her interest from her husband, giving him notes for the purchase money, these notes to be paid out of her share of firm earnings, this purchase being made by her after her husband had unsuccessfully attempted to sell out his interest to his brothers and his father (also partners) on somewhat similar terms.[21]

More frequently, however, the wife is without capital of her own, and her capital investment in the firm is derived by way of gift from her husband. Sometimes capital in one form or another is given to the wife, and then invested by her in the business. Sometimes the husband merely assigns a part interest in the business to her, and in so doing creates the partnership. The result is the same, regardless of the procedure followed. The wife (or child) becomes a partner in the business, on the basis of her alleged ownership of a capital interest in the firm, which capital interest was acquired by her by way of gift from her husband.

Nor is there anything inherently improper or invalid in such a procedure. In fact, it has been frequently held that, in a mercantile or manufacturing business (or similar enterprises where capital is a significant factor in business success), "a husband and father . . . can make his wife and minor children partners in the business by making bona fide gifts to his wife and/or children of an interest in the business assets and then entering into a partnership agreement with the wife and/or children, they contributing as their part of the capital . . . the interests which have been given to them by the husband father."[23]

In passing, special note should perhaps be made of the references in the above quotation to children as partners. The inclusion of minor children in the partnership has been frequently sustained, and the validity of the minor child's status as a partner seems to be governed by the same rules

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the wives obtained their capital by gift and inheritance from their own families.

21. J. D. Johnston, 3 T. C. ——, No. 101.

22 Quoted from Robert P. Scherer, 3 T. C. ——, No. 100. See Justin Potter v. Commissioner of Internal Revenue, 47 B. T. A. 607 (1942); Walter M. Moyer v. Commissioner of Internal Revenue, 35 B. T. A. 1155 (1937); Jasper Sipes v. Commissioner of Internal Revenue, 31 B. T. A. 709 (1934); Estate of Barringer, Memo B. T. A. opinion, Sept. 16, 1942; James O. Peterson, Memo T. C. opinion, Oct. 30, 1943; Hardymon v. Glenn, ——, F. Supp. —— (Ky., June 28, 1944); dicta in W. P. Sewell, Memo T. C. opinion, Feb. 7, 1944.

exactly as govern the status of the wife as a partner. The attempt to include minor children as partners in a professional or personal service type of business has been unsuccessful, just as the attempt to include the wife has failed in such cases, where the child or wife contributes neither capital nor services.[23] But the Tax Court has recently and clearly held that "a parent engaged in a business involving a substantial capital investment may constitute his minor children partners . . . by making them bona fide gifts of an interest therein, either directly or by means of trusts."[24] An even more successful procedure was that used in one case where the husband included the wife as partner, and she later assigned part of her interest to certain trusts for their children, this re-assignment by her not only resulting in recognizing the children as partners, but also being deemed evidence of the unrestricted nature of the gift to her.[25]

It is clear, therefore, that the wife can invest, in a partnership with her husband, a capital interest donated to her and received by gift from her husband. But it is equally clear that, in such a case, there must be an absolute irrovocable, bona fide, and complete gift to the wife, with no "understandings" as to her exercise of her rights, no indirect control retained by the husband, no conditional gift solely for the purpose of creating a fictional partnership.[26] There should

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23. See Tinkoff v. Commissioner of Internal Revenue, 120 F. (2d) 564 (C. C. A. 7th, 1941); Edward J. Miller, Memo T. C. opinion, March 18, 1944, where son and daughter were included, and were of age, but were rejected as partners the same as the wife.

24. Quoted from Irene McCullough, Memo T. C. opinion, July 19, 1944. See Robert P. Scherer, 3 T. C. ——, No. 100, where the husband made capital gifts to the wife, individually, and to her as trustee for their minor children; Richard H. Oakley v. Commissioner of Internal Revenue, 24 B. T. A. 1082 (1931), where the husband likewise assigned partnership interests to the wife individually, and to her as trustee for their minor children; Justin Potter v. Commissioner of Internal Revenue, 47 B. T. A. 607 (1942), where the husband and wife, already partners together, joined in assigning certain interests in the firm to their minor children, and the father managed the interests of the children as guardian; Wachovia Bank (Stanback) v. Commissioner of Internal Revenue, Memo T. C. opinion, June 22, 1944, where the husband assigned part of his partnership interest to his brother as trustee for his wife and children; Armstrong v. Commissioner of Internal Revenue, —— F. (2d) —— (C. C. A. ——, July 6, 1944); Hardymon v. Glenn, —— F. Supp. —— (Ky., June 28, 1944).

25. Walter M. Moyer v. Commissioner of Internal Revenue, 35 B. T. A. 1155 (1937).

26. A. L. Lusthaus, 3 T. C. ——, No. 67.

be such a gift that the court can say, as it did in one case, that "no issue is raised that (the husband-father) did not make valid, completed gifts to his wife individually, and to his children in trust."[27]

In short, to go back to the basic premise, there must be a partnership in *fact*, not merely in *form*.

THE INDICIA OF INVALIDITY

All too often, the gifts to the wife, invested as capital in the family partnership, have NOT been real and bona fide. The courts have repeatedly been forced to find, on the facts before them, that there was no intention of making the wife a full and legal partner in the business, no intention of letting her exercise her full and real rights as a partner, and therefore no actual and legitimate partnership structure despite the alleged gift of capital and the alleged creation of a partnership enterprise.

What are some of these facts revealing the colorable nature of the transaction, some of these indicia of invalidity that have been seized upon by the courts in family partnership cases and indicating that the claimed partnership was non-existent in fact?

(a) *Lack of Formal Agreements*: While oral partnership arrangements between members of the family have been upheld,[28] particularly where the oral arrangements included others than the wife and children, it is quite clear that the lack of any formal, written partnership contract and agreement will prove to be rather strong evidence of the fictitious character of the claimed partnership. For instance, merely indicating a transfer of certain interests to the wife and four children, in entries on the books of the business, will not be enough to show a real partnership relation, especially, when coupled with other facts such as evidence that there was no actual participation in the business by the alleged partners.[29] Certainly, there should be a formal partnership agreement

27. Robert P. Scherer, 3 T. C. ——, No. 100.

28. Arthur Stryker v. Commissioner of Internal Revenue, 17 B. T. A. 1033 (1929); Charles Tift v. Commissioner of Internal Revenue, 25 B. T. A. 986 (1932); Justin Potter v. Commissioner of Internal Revenue, 47 B. T. A. 607 (1942).

29. W. P. Sewell, Memo T. C. opinion, Feb. 7, 1944; Francis E. Tower, 3 T. C. ——, No. 49, where the wife testified that her capital interest "was just credited to me on the books."

entered into between the parties the same as would be prepared if the partnership were with strangers. The importance of this point is illustrated by one case where a partnership was rejected because of lack of any tangible agreement, and was later upheld for later tax years after the execution of a formal partnership contract between husband and wife.[30] Similarly, in another case, the partnership was upheld only from the date of the formal written contract, notwithstanding that the wife admittedly rendered real and substantial services for many years prior to that writing.[31] Again, a family partnership was said by the Tax Court in another case to be "evidenced by proof of the strongest character, i.e., by a written instrument signed by (the husband) and his wife, duly acknowledged by both, and delivered to the wife."[32]

(b) *Failure to Record Partnership*: The failure to register or record the partnership as required under many state laws may also prove damaging as evidence of lack of reality and legality in the arrangement.[33] It may be noted in this connection that under Indiana statutes, if the business is operated under a name that does not reveal the true surnames of all partners, a certificate must be filed with the clerk of the circuit court of the county where the business has its offices.[34] Failure to so register the firm name and the members of the partnership would undoubtedly be an indication that the partnership had not been formally and legally recognized, where the business continued under its former name. The fact that the formal partnership agreement HAD been recorded as required under state law was noted in several cases upholding family partnerships, as at least evidence of reality.[35]

(c) *Limited Partnership*: The fact that the wife was

30. Elizabeth M. Coombs v. Commissioner of Internal Revenue, 25 B. T. A. 1320 (1932).
31. Felix Zukaitis, 3 T. C. ——, No. 102.
32. M. W. Smith, 3 T. C. ——, No. 110.
33. Ed Kasch and Theodora Kasch v. Commissioner of Internal Revenue, 25 B. T. A. 284, 287 (1932); Frank J. Lorenz, 3 T. C. ——, No. 98.
34. Ind. Acts 1909, c. 151, § 1, Ind. Stat. Ann. (Burns, 1933) § 50-201.
35. Sidney Nathan, Memo T. C. Opinion, May 14, 1943; Justin Potter v. Commissioner of Internal Revenue, 47 B. T. A. 607 (1942), where the failure to record the partnership was noted, but was deemed of no significance since such action was not required under the laws of the state involved.

merely a limited partner, without management power or responsibility, has proved damaging in several cases, as indicative of a lack of full partnership status.[36] In one case, the wife's participation as a limited partner was approved, and the partnership upheld notwithstanding that fact; but it may be noted that the surrounding facts were extremely favorable, the court expressly stating that "the evidence that the rights to which the wives were entitled were exercised by them free of control of the (husbands) is *uncontradicted.* They have the full legal right to sell . . . the whole part of their interests to such persons and at such times as they wish."[37] In the face of clear and undisputed evidence of the bona fide nature of the transaction, the fact of limited partnership becomes unimportant in and of itself,[38] but it is nevertheless a dangerous fact.

It is clear that management of the business CAN be delegated to the husband as general partner;[39] but such delegation, limiting the wife's participation, will, it is equally clear, be viewed with some suspicion as tending to make her participation unreal; and when coupled with *other* indicia of invalidity, may result in an adverse decision.

(d) *Lack of Voice in Management*: Where the wife, as part of the formal partnership agreement or by tacit understanding with the husband, agrees to exercise no voice in the management of the business, the partnership is quite likely to be rejected as unreal, since that is one of the common attributes of a real partnership relationship.[40] For instance, in rejecting a wife as partner in her husband's insurance

36. R. W. Camfield, Memo T. C. opinion, Feb. 9, 1944; Francis E. Tower, 3 T. C. ——, No. 49; O. W. Lowry, 3 T. C. ——, No. 97; W. P. Sewell, Memo T. C. opinion, Feb. 7, 1944.

37. Sidney Nathan, Memo T. C. opinion, May 14, 1943.

38. Limited partnership ignored in Wachovia Bank (Stanback) v. Commissioner of Internal Revenue, Memo T. C. opinion, June 22, 1944.

39. Clinton Davidson v. Commissioner of Internal Revenue, 43 B. T. A. 576 (1941); Charles Tift v. Commissioner of Internal Revenue, 25 B. T. A. 986 (1932); N. H. Hazlewood v. Commissioner of Internal Revenue, 29 B. T. A. 595 (1933); Walter M. Moyer v. Commissioner of Internal Revenue, 35 B. T. A. 1155 (1937); Robert P. Scherer, 3 T. C. ——, No. 101; Wachovia Bank (Stanback) v. Commissioner of Internal Revenue, Memo T. C. opinion, June 22, 1944.

40. R. W. Camfielf, Memo T. C. opinion, Feb. 9, 1944; Francis E. Towser, 3 T. C. ——, No. 49; O. W. Lowry, 3 T. C. ——, No. 97; Frank J. Lorenz, 3 T. C. ——, No. 98; Mead v. Commissioner of Internal Revenue, 131 F. (2d) 323 (C. C. A. 5th, 1942).

business, the court noted that "it was not intended that she have any voice in the business," as evidenced by the husband's testimony that she had no insurance license and "we didn't intend for her to have one."[41]

(e) *Restrictions on Wife's Rights as Partner*: The imposition of restrictions on the wife's right to exercise her normal legal rights as a partner (such as provisions under which she can not assign her interest without the consent of the husband, provisions limiting her power to bind the partnership, provisions restricting her right to withdraw from the firm, or restricting her right to withdraw her share of the profits) tends to show that the wife was never intended to possess a real and full bona fide partnership interest.[42] The existence of such restrictions is generally dangerous if not fatal to the claim of partnership.[43]

The wife certainly should have all of the power and authority normally inherent in the partnership relationship, if the reality of the partnership is to be free from question.[44]

(f) *Reversion to Husband at Termination of Firm*: A provision under which all firm property vests in the husband on termination of the partnership during his lifetime is bound to raise strong suspicions as to the reality of the part-

41. Earp v. Jones 131 F. (2d) 292 (C. C. A. 10th, 1942).

42. O. W. Lowry, 3 T. C. ——, No 97; Frank J. Lorenz, 3 T. C. ——, No. 98, where husband had unlimited drawing account, and wife had no drawing account; R. W. Camfield, Memo T. C. opinion, Feb. 9, 1944. But cf. Walter M. Moyer v. Commissioner of Internal Revenue, 35 B. T. A. 1155 (1937).

43. Note also those cases where the ABSENCE of such restrictions has been favorably noticed by the court, as in Clinton Davidson v. Commissioner of Internal Revenue, 42 B. T. A. 576 (1941), where the court observed that the wife could withdraw from the firm on written notice, in which event the capital interest was to be divided half and half. See also Justin Potter v. Commissioner of Internal Revenue, 47 B. T. A. 607 (1942), where the court observed that the "donor did not make gifts with strings attached. No powers were reserved as conditions of the gift"; Sidney Nathan, Memo T. C. opinion, May 14, 1943, where the wife's unlimited and unrestricted right to withdraw and sell her interest even overbalanced the adverse fact of limited partnership, as noted earlier.

44. Francis Doll, 2 T. C. 276; Elizabeth M. Coombs v. Commissioner of Internal Revenue, 25 B. T. A. 1320 (1932); Justin Potter v. Commissioner of Internal Revenue, 47 B. T. A. 607 (1942), involving children as partners, where the court did not overlook the fact that the father managed and operated the business as guardian, and failed to open separate accounts for the children, and observed that more careful procedure "would have eliminated some of the (government's) questioning of the status of the matter in general."

nership.[45] Certainly, it can hardly be said that the gift to the wife of a capital interest in the firm was irrevocable, complete and indefeasible in the face of such a clause in the partnership contract.

(g) *Capital Gift Conditioned on Use in Firm*: Similarly, where the gift of a capital interest to the wife is not free and unconditional, but is conditioned on the investment of the capital in the business, questions may be raised; and such a conditional gift, is a clear ear-mark of unreality in the transaction.[46] In one case, a husband gave his wife $50,000 outright, paying gift tax thereon. She then used this money, plus an additional $55,000 of her personal notes, plus a small amount of her own cash, to buy a half interest in the hus-ditioned on the use of the funds in forming the partnership, agreement, it was held that the partnership was unreal and non-existent, because the husband's gift of $50,000 was conditioned on the use of the funds in forming the partnership, and because there was no real liability intended on the wife's notes, with the result that the alleged purchase was fictional.[47] Similarly, where there was no "unconditional gift" of the capital interest, since the wife "could only use it in one way, namely, to place . . . the assets . . . into the partnership," the transfer of the capital interest was held "more fanciful than actual since there was no purpose to the (transaction) apart from the agreed plan that the gift would determine her interest in the partnership."[48]

Contrarily, where the taxpayer was advised by his accountant that following gifts of corporation stock to his wife and children, they would *not* be obliged to go along with him in dissolving the corporation and forming a partnership, and he required that the gifts be absolute with no strings attached, the partnership formed later after dissolving the corporation was held valid in fact.[49]

THE INDICIA OF VALIDITY

If facts such as we have reviewed indicate lack of reality in the partnership arrangement, what facts tend to es-

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45. R. W. Camfield, Memo T. C. opinion, Feb. 9, 1944.
46. O. W. Lowry, 3 T. C. ——, No. 97.
47. A. L. Lusthaus, 3 T. C. ——, No. 67.
48. Francis E. Tower, 3 T. C. ——, No. 49.
49. Hardymon v. Glenn, —— F. Supp. —— (Ky., June 28, 1944).

tablish a real and bona fide arrangement, to show a vesting of full and complete ownership in the wife-donee of a capital interest in the firm, a clear and complete vesting of the rights of genuine partnership? Some of the indicia of validity may be derived from the facts in the reported cases, both these which involved capital interests donated to the wife, and other family partnership cases.

(a) *Revelation of Relationship to Public*: Evidence that the partnership relationship was clearly revealed to the public at large, and was generally recognized by the public will prove helpful,[50] as where the wife's interest was made known to the bank in financial statements and in connection with firm borrowings.[51] Contrarily, for example, where the husband orally announced the partnership to his accountant and certain business associates, but filed financial statements with the bank showing himself as sole owner of the business, the failure to reveal the partnership at the bank was pointed out by the Court as evidencing a lack of reality in the partnership.[52] Evidence that the partnership was openly proclaimed to the public, as where suits were brought in the name of the husband and his wife as "partners, trading as the J. Howard Coombs Lumber Company," indicated a bona fide arrangement.[53]

(b) *Withdrawal of Funds*: The withdrawal of funds by the wife, and the use of these funds to pay the personal debts of the wife, has been noted in some cases.[54] Similarly, where the wife had the right, as partner, to draw checks on the partnership account, and frequently exercised this right, these facts were noted as evidencing a real partnership structure.[55] As a proper corollary, where the taxpayer's 79-year-old father was made a partner, and made only nominal withdrawals against some $110,000 of profit credits, and was given the right to draw checks on the partnership only after revenue agents started their investigation, the partnership was held unreal.[56]

50. Estate of Barringer, Memo B. T. A. opinion, Sept. 16, 1942.
51. James O. Peterson, Memo T. C. opinion, Oct. 30, 1943.
52. W. P. Sewell, Memo T. C. opinion, Feb. 7, 1944.
53. Elizabeth M. Coombs v. Commissioner of Internal Revenue, 25 B. T. A. 1320 (1932).
54. R. C. Bennett, Memo B. T. A. opinion, ——; M. W. Smith, 3 T. C. ——, No. 110.
55. J. D. Johnston, 3 T. C. ——, No. 101.
56. Blalock v. Allen, —— F. Supp. —— (Ga., July 19, 1944).

(c) *Transfer of Interest by Wife*: Where the wife exercises her unrestricted proprietary rights in her partnership interest, as where she received a $100,000 interest in the husband's business by gift from the husband, and later created trusts for her children, out of her own interest in the firm, there is evidence of a bona fide transaction. Such a re-transferring of her acquired interest in the firm was considered in one case as strong evidence of full ownership on her part.[57]

(d) *Participation in Management*: Actual participation by the wife in the management affairs of the firm is also indicative of real partnership stature on her part.[58] Consultation with the wife with regard to the expansion of the business, matters of personnel, and other questions of importance, she having an intimate knowledge of the business, is evidence of her participation as a full partner.[59]

(e) *Consent of Other Parties*: The fact that other persons are concerned in the business and have consented to the wife's participation as a partner and recognized her as such is also evidence of real partnership status. In several cases, the fact that other partners consented to the wife's entrance into the firm was noted by the court.[60] For instance, in one case the United States Circuit Court of Appeals made much of the fact that "all (partners) consented to the trust (for the taxpayer's children) becoming a member of the partnership," and that "all of the members of the partnership knew that the trust was a partner."[61] Similarly, where a husband and wife partnership in a Coca Cola franchise was subject to approval by the parent distributing company, and such approval was asked and obtained, there was evidence of a real partnership.[62]

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57. Walter M. Moyer v. Commissioner of Internal Revenue, 35 B. T. A. 1155 (1937).
58. Ibid.
59. Arthur Stryker v. Commissioner of Internal Revenue, 17 B. T. A. 1033 (1929).
60. Jasper Sipes v. Commissioner of Internal Revenue, 31 B. T. A. 709 (1934); Justin Potter v. Commissioner of Internal Revenue, 47 B. T. A. 607 (1942); J. D. Johnston, 3 T. C. ——, No. 101; Burnet v. Leininger, 285 U. S. 136 (1932), where a wife was NOT recognized as a partner because the other partners in the firm had NOT approved or consented to her membership.
61. Armstrong v. Commissioner of Internal Revenue, —— F. (2d) —— (C. C. A. ——, July 6, 1944).
62. N. H. Hazlewood v. Commissioner of Internal Revenue, 29 B. T. A. 595 (1933).

(f) *Evidence of Accounting to Wife*: While in most family partnership cases, adequate accounts have been kept of the shares of the partners, it is helpful also to keep the wives informed with regular statements of business progress.[63]

SUMMARY AND CONCLUSION

Such are the guideposts to the reality or non-existence of the family partnership. There are other points, not revealed or noted in any of the cases reviewed in this discussion, which might well prove important in showing the validity of a family partnership. For instance, an estate survey, re-examining the wife's estate situation in the light of the partnership interest acquired by her, accompanied by tax computations assuming her full ownership of this interest and its taxability in her estate, might well indicate her assumption of full ownership, particularly when followed by positive acts such as a revision of her will to include provisions directing the executor in his handling of her partnership interest.

The development by the husband and wife of purchase and sale agreements with respect to their partnership interests in case of death, supported with life insurance to improve the liquid position of their respective estates, might also indicate that the parties conceived themselves to be genuine partners. Other points may come to the mind of the attorney or accountant in connection with his particular case. It is not pretended that this survey is all-inclusive in its review of pertinent facts.

Moreover, it is obvious that no SINGLE fact is necessarily controlling and decisive in any given case. It is the accumulation of evidence either for or against the reality of the partnership that proves or disproves the fact of partnership. In the final analysis, the problem is one of weighing the evidence and reaching a decision as to the facts in the given case. There exists in *every* family partnership case what one court described as "a somewhat difficult problem

63. See Charles Tift v. Commissioner of Internal Revenue, 25 B. T. A. 986 (1932), where regular monthly statements were made to the wives and noted as evidence of their participation in the management; Thomas M. McIntyre v. Commissioner of Internal Revenue, 37 B. T. A. 812 (1938), where the lack of accounting to the wife was noted as evidence of no real partnership status on her part.

in the weighing of the evidence."[64] And as long as family partnership cases remain "fact" cases, as they inevitably must, and as long as judges are human and differ in their interpretation of given facts, there will be difficulties in these cases because there always "is room for differences of opinion upon the real situation which the facts present."[65]

Few family partnership cases indeed will be letter perfect. In most of them, there will be some indicia of invalidity and some indicia of validity present in the facts. The question, then, is simply—"How many and how strong are the facts pointing one way or the other?" The measuring rods are not precise. There is always the human element, different minds viewing the same facts and reaching different conclusions, particularly where the case is close and there is no preponderance of indicia one way or the other. But they are the only measuring rods that are available; and used judiciously they can indicate rather accurately the relative strength or weakness of almost any particular case.

REASONABLE CORPORATE SALARIES

BRUCE H. JOHNSON*

Corporations, under Section 23(a)(1) of Internal Revenue Code, are afforded deductions in computing net income of all ordinary and necessary expenses paid or incurred in carrying on any trade or business, including "a reasonable allowance for salaries or other compensation for personal services actually rendered." The decisions which have interpreted this Section, present in every Revenue Act since 1918, indicate that there are three tests for determining reasonable salary deduction: (1) Is the payment in fact salary or other compensation; (2) Have personal services been actually rendered; and (3) Is the payment reasonable when measured by the amount and quality of the services performed with relation to the business of the particular taxpayer?[1]

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64. Dissenting opinion in Felix Zukaitis, 3 T. C. ——, No. 102.
65. Dissenting opinion in J. D. Johnston, 3 T. C. ——, No. 101.

* Of the Indianapolis Bar.

1. See Lenox Clothes Shops, Inc. v. Commissioner of Internal Revenue, 139 F. (2d) 56 (C. C. A. 6th, 1943). See also Mertens, "Law of Federal Income Taxation" § 25.44.

It is expected that these tests will be applied frequently in the future. The great increase in corporate profits and the increasingly heavy tax burdens on corporations, together with increased costs of living of employees caused the corporations to grant substantially higher corporate salaries even before the salary and wage controls were put into effect. I do not intend to discuss the effect of those controls upon the allowances by the Treasury Department of corporate salaries as reasonable in amount, but I think it is agreed that any increases granted by the National War Labor Board or the Salary Stabilization Unit of the Treasury Department will be a substantial deterrent to the Commissioner's holding that such corporate salaries are unreasonable; on the other hand, I think it must be admitted that the Commissioner is not required to hold such salaries reasonable merely because they have been approved by those agencies. We trust that these controls are of only a temporary nature, but it is expected that salaries prior to the institution of those controls and also subsequent thereto will be subjected to these three time honored tests. So let us consider them, the factual situations to which they have been applied and the decisions of the Court resulting from their application.

Is the payment in fact salary or other compensation? In determining whether a payment to an employee of a corporation is compensation for services, it is well to inquire "if the payment is not salary, what is it?" Well, (1) it might be a distribution of profits, or dividends in the form of a salary payment, or (2) it might be actually payment for the purchase of property, or (3) it might be a gift.

1. In a close corporation, the temptation is very great to distribute profts in the form of salaries. Let us assume a case in which one stockholder owned sixty per cent of the stock and another forty per cent of the stock, both being actively employed by the corporation. Let us further assume that each drew $10,000.00 compensation for the year 1938, in which a profit of $25,000.00 was made. In 1939 the profit would have increased $10,000.00 except for the fact that the larger stockholder's salary was increased $3,000.00 and other stockholder's salary was increased $2,000.00. It can easily be seen that it would be difficult to convince the Commissioner that these increases, being in direct proportion to the stockholdings were not actually div-

idends in disguise. It is easy to see that the weak points in the taxpayers' case are that the increases are directly proportional to the stockholdings and that the stockholders have no interest in bargaining with themselves to keep their salaries low, but on the contrary stand to make substantial tax savings if the highest maximum salaries are paid. Such increases in salary are subject to the closest scrutiny, and when determined to be not salary but a distribution of profits, the presumption in favor of the correctness of the Commissioner's disallowance of the excessive salaries can be overcome in the Court only by the clearest proof.[2]

2. An example of an ostensible salary payment which is in reality a payment for property is given in the Regulations.

> "This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business."[3]

Another illustration is where a selling agent is paid a commission both for sales and also for his promise not to engage in a similar competing business during the life of the contract. Insofar as the commission is paid for refraining from engaging in business, it is a payment for property.[4]

It is infrequently contended that payment to an employee constitutes a gift. The question may arise when the recipient excludes that amount from his own gross income while the corporation tried to take a deduction for that amount as compensation. Such a case arose in *Willkie vs. Commissioner,*[5] Wendell's brother, Herman, resigned in 1937 from one of the Hiram Walker corporations. In accepting his resignation, the Board moved that he be given a check for six months' salary in appreciation of his services. The recipient refused to accept this at first but upon being told that the "gift" had been unanimously voted, he thereupon accepted it. The

2. Cf. C. S. Ferry & Son, Inc. v. Commissioner of Internal Revenue, 18 B. T. A. 1261 (1930); General Water Heater Corporation v. Commissioner of Internal Revenue, 42 F. (2d) 419 (C. C. A. 9th, 1930).
3. C. C. H. Fed. Tax Serv. 157, Reg. 103, § 19.23 (a)-6 (1942).
4. 3 Cum. Bull 133, L. O. 1045 (1920).
5. Willkie v. Commissioner of Internal Revenue, 127 F. (2d) 953 (C. C. A. 6th, 1942).

paying corporation treated it as a deductible expense, and this was one of the factors taken into consideration in deciding that the recipient had to treat it as taxable income to him and not a gift.

The leading case on this subject is probably *Bogardus vs. Commissioner.*[6] Unopco Corporation took over the assets and business of the Universal Company, and the stockholders of the successor corporation voted "gifts or honorariums" totalling $600,000.00 to the employees of the Universal Company. The Supreme Court held by a five to four decision that the Tax Court decision should be overruled, and that the recipients of those so-called gifts were not taxable thereon. One of the relevant factors considered was that the paying corporation had not sought any deduction from its federal tax on account of those payments. It is thus clear that consistent treatment by both the payor and the payee in these situations is required to show that the payment is a gift.

Is the payment made for personal services? Payments to the members of the family of the dominant stockholder or principal operator of the business often fail before this test. Theoretically that relationship should not affect the action of the Board of Directors in determining a reasonable salary, but such situations invite the closest scrutiny by the Bureau of Internal Revenue, and where the services performed are not substantial, a disallowance will be upheld. In addition, where the motivating factor of payment is the desire to reduce an employee's indebtedness[7] or to make a loan[8] or to aid a sick employee,[9] it is considered that the payment is not for personal service actually rendered. It should be noted, however, that salaries paid to former employees who are now in military service are allowable as a deduction.

Is the compensation payment reasonable? Undoubtedly the factual determination of the reasonableness of the compensation paid is of utmost importance. Because the question is one of fact, and because practically every situation involves some difference in fact, only generalization can be

6. Bogardus v. Commissioner of Internal Revenue, 302 U. S. 34 (1937).
7. Foregger Co., Inc. v. Commissioner of Internal Revenue, 13 B. T. A. 920 (1928).
8. Kossar & Co., Inc. v. Commissioner of Internal Revenue, 16 B. T. A. 952 (1928).
9. Snyder & Berman, Inc. v. Commissioner of Internal Revenue, 116 F. (2d) 165 (C. C. A. 4th, 1940).

made. Even before the recent decision emphasizing the finality of Tax Court decisions on matters of fact, the upper courts have been reluctant to change the holdings below. A careful presentation of the case is therefore necessary, at the earliest opportunity, if the corporate taxpayer's deductions are to be sustained. Like the determination of any ultimate fact, the reasonableness of the compensation requires the consideration of many different factors.

Where the directors deal at arms' length with employees in the fixing of salaries, the amounts agreed upon as a result of such a bargain are generally accepted. This guarantee of reasonableness, however, is quite often lacking, as the salaries in question are usually those of persons who dominate and control the directors. In such cases, the action of the board of directors has very little weight with the Commissioner and with the courts. And if the Commissioner determines compensation to be of an unreasonable amount, the taxpayer has the burden of overcoming the presumption in favor of the correctness of the Commissioner's determination. He can do this by showing the amount to be reasonable. If it can be shown that a like enterprise, under like circumstances, would ordinarily pay the same amount for like services, the compensation will be deemed to be reasonable.

With this in mind, it becomes apparent that factors to be considered are the size of the enterprise, the area in which it is located, the type of industry represented, the general economic conditions, the financial soundness of the corporation, the result obtained under the employment contract, the ratio of the questioned salary to other salaries within the business and similarity of employees in like industries with similar qualifications, the salary policy of the corporation, the employees' qualifications and the scarcity of other persons with comparable qualifications, the amount of time devoted to the business, and every other consideration that may enter into the question of whether an employee is worth what he is being paid. In the usual case, some of the facts will indicate that the salary paid is reasonable; while others will operate to show the opposite. A determination, however, is not so difficult as the abstract weighing of these factors would indicate, because in a particular case the decisive factors usually are apparent. It would require too much

time to illustrate the application of all these factors by cases, and so only a few isolated examples will be used.

The case of *William S. Gray & Co. vs. United States,*[10] is often cited by the taxpayer and with good reason. The plaintiff was a New York corporation engaged in importing and exporting chemicals. During the years 1916, '17 and '18, compensation was paid to six key employees in amounts ranging from $7,500.00 to $257,714.30. This maximum was received by Mr. Gray in 1916, and in 1917, he received $139,000.00 and in 1918, $84,000.00. The Company practice had been to use all of the profits in excess of 7% of the capital stock as bonuses to be distributed among key employees. Mr. Gray owned 80% of the stock, but his bonus was only 57% of the profits. The salaries paid were declared to be reasonable, and the following factors there considered seem to be controlling:

(a) Although the corporation was closely held, bonuses granted were not in proportion to stockholdings.

(b) The Company's practice of determining bonuses had been fixed and applied for some time previous to the years in question.

(c) The business of the corporation was personal in nature, and its profits depended primarily upon the exertions of the key employees.

(d) The services by the corporation were almost unique (they imported approximately 95% of the acetate of lime and wood distillation business in the country), and it would have been difficult to have found other qualified employees. In a manufacturing chemical company, the three heads of the business received fixed annual salaries of $100,-000.00 per year, and Mr. Gray's salary over a nine-year period amounted to $99,303.29 average per year.

The reasons this case is such a favorite of taxpayers are that very substantial amounts were approved to the chief stockholder of a closely held corporation, and it is a "bonus" case. And because the bonus or contingent method of compensation is related so closely to a distribution of profits, much litigation has resulted.

Theoretically, a payment of $10,000.00 per year with a $5,000.00 bonus is just as reasonable as a $15,000.00 salary for the same job. But the agent who examines the corpor-

10. William S. Gray & Co. v. U. S., 35 F. (2d) 968 (Ct. Cl., 1925).

ate return may regard the $10,000.00 per year salary as reasonable and the addition of another $5,000.00 out of the profits as excessive. He may be further convinced if he finds that the recipient is a large stockholder of the company and that he previously received only $10,000.00 per year. If that happens to a client of yours, you had better have some good answers.

What would be some good answers? Well, if you can show that he had received an offer from another company of $15,000.00 per year, that would be a very good answer. If you could show that some new line of business had been taken on successfully, that would help. If the company made sufficient money to pay greater dividends than usual—and did so—, or if his work was primarily concerned with sales, and commissions customarily paid in the industry would have approximated $15,000.00 if he had been so employed; or if you could show John Smith in the XYZ Company, who performed substantially the same services for a company in the same industry having about the same volume of business, received $15,000.00 or better; or if you could show that your client had had to employ a stranger at say $12,000.00 per year and the stranger had a less responsible job than the person who got $15,000.00; if you can show any or all of these factors, there is a good chance the agent will change his mind and allow the bonus. The point is, there has to be some good reason for paying particular amounts of salaries, or they are "unreasonable."

If one of your corporate clients has an officer's salary disallowed as unreasonable, in your search of cases to justify the allegedly excessive compensation, you will probably find the case of *Lucas v. Ox Fibre Brush Co.* useful.[11] In that case, $24,000.00 each was voted to two officers who had been with the company for seventeen years, and the compensation paid was allowed for past services. The business had grown and prospered under the guidance of these two employees, and these increased salaries were to make up for inadequate payment when the corporation was not so able financially. The resolution authorizing the payments recited that they were for past services, and that is probably an important distinction between your case and the Ox

11. Lucas, Commissioner of Internal Revenue v. Ox Fibre Brush Co., 281 U. S. 115 (1930).

Fibre Brush Co. case. The Courts are not inclined to regard favorably the principle of this case where it is brought forward as an afterthought. However, in *Webb & Bocorselski, Inc.*,[12] and *Detroit Vapor Stove Co.*,[13] among others, favorable consideration was given to the fact that prior years' salaries had been inordinately low.

Before discussing some practical suggestions, I would like to mention two recent cases: *Frederick Webb Estate v. Commissioner,* Tax Court Memo Opinion decided May 8, 1944 (reported in CCH as Dec. 13, 929(M.), and *J. L. Norie v. Commissioner,* 3 TC ——, No. 89 (CCH Dec. 13, 885).

In the *Webb Estate* case, some unlisted stocks were valued on the basis of capitalization of corporate earnings. Although the Commissioner had allowed the salaries for income taxes, the court held that the earnings of the corporation should be increased by the amount of salaries deemed excessive, and the value of the stock determined on the earnings as adjusted.

In the *Norie* case, it was held that the payment of salaries to employees who admittedly performed no services justified the imposition of the 50% fraud penalty. This case relies upon *Allegheny Amusement Co. v. Comm.*[14] and in the latter case, the fraud was availed of also to reopen many prior years.

These two taxpayers made no contention that any services were actually performed. Usually, some effort is made to show rendering of service, even if all that can be shown is that the wife (the Vice-President) sometimes discussed business affairs with her husband (the President) after dinner, and occasionally dropped in at the office. Well, maybe those services are valuable if they prevent the imposition of fraud penalties. In the case of *United States v. Ragen,*[15] however, it was held that criminal penalties for fraud may be upheld even though some slight service was rendered.

In conclusion, I wish to offer some suggestions.

1. When fixing corporate salaries, do it by formal resolution. And if an increase is granted for any particular reason, state the reason.

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12. Webb & Bocorselski, Inc. 1 B. T. A. 871 (1925).
13. Detroit Vapor Stove Co., 4 B. T. A. 1043 (1926).
14. Allegheny Amusement Co. v. Commissioner of Internal Revenue, 37 B. T. A. 12 (1938).
15. U. S. v. Ragen, 314 U. S. 513 (1941).

2. Fix salaries, especially contingent salaries, at the beginning of the year. This tends to show that compensation was determined with reference to a bargaining for services and not as a distribution of profits.

3. If increases are given to stockholder-employees, give some increases to non-stockholders, too.

These suggestions should help to avoid controversy, if the salaries are not extravagant.

If corporate salaries are disallowed, investigate your case from every angle and present it ably and early. Many a corporate salary case has been lost through inadequate preparation and poor presentation.

Try to find comparable enterprises, and back your argument with facts. This particular task is not easy, since competitors may not be too friendly, and don't forget that the Commissioner has more comparative data than you can hope to produce.

But you can analyze the employee's qualifications and responsibilties. You can show ratios of salaries to gross income, to net income and dividends. You can show other prior and subsequent offers for the employee's services, the additional duties imposed on him, the practical results obtained from his services, the cost of replacing him, the comparative unemployment cycles, general business conditions, the economic history of the corporation; if the employee is on a salary basis, what he would have made on commissions; if on commissions, that the average over a period of years is no more than he would have received on a straight salary basis. Stress differences in compensation and stockholdings. Draw up comparative statements, analyses, charts.

Of course, all the factors you investigate won't be to your advantage. But you ought to find enough favorable indications to satisfy yourself that the employee didn't get half enough.

The Government has a strong defense in the presumption that the Commissioner's determination is correct. It is so strong that quite often it is the only defense offered, and it cannot be overcome just by citing cases. But it can be overcome with facts. So arm yourself with facts, and they will become the reasons that make the compensation "reasonable."