3 T.C. 396 (1944)

A partnership is not recognized for tax purposes if it is formed primarily to reallocate income within a family and the family member partner contributes neither capital originating from themselves nor services to the business.

Summary

Francis Tower sought to reduce his tax burden by forming a partnership with his wife, Hazel. Prior to forming the partnership, Tower owned a successful machinery manufacturing business as a corporation. He gifted shares of stock to his wife shortly before dissolving the corporation and forming a partnership where she was a limited partner. Hazel contributed capital derived from the gifted stock but provided no services to the partnership. The Tax Court held that the partnership was not bona fide for tax purposes because Hazel's capital contribution was essentially a gift from her husband and she provided no services. Therefore, the income attributed to Hazel from the partnership was taxable to Francis.

Facts

Francis E. Tower operated a machinery manufacturing business, R.J. Tower Iron Works, initially as a corporation where he owned most of the stock.

In 1937, Tower decided to dissolve the corporation and form a partnership to reduce taxes.

Prior to dissolution, Tower gifted 190 shares of corporate stock to his wife, Hazel, conditional on her investing those assets into the new partnership.

A limited partnership agreement was formed between Tower, his wife Hazel, and an employee Amidon. Hazel was designated as a limited partner.

Hazel contributed capital to the partnership based on the value of the gifted stock, but she provided no services to the business and had no prior business experience.

The business operations remained substantially the same after the partnership formation as they were under the corporation, with Francis Tower managing the business.

Hazel received a share of the partnership profits, but these funds were largely controlled by Francis and used for family expenses.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Francis Tower's income tax returns for fiscal years 1940 and 1941, arguing that income attributed to Hazel Tower from the partnership should be taxed to Francis.

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Francis Tower petitioned the Tax Court to contest the Commissioner's determination.

Issue(s)

1. Whether the gift of corporate stock from Francis to Hazel Tower was a bona fide gift for tax purposes, such that Hazel's capital contribution to the partnership could be considered her own.

2. Whether a valid partnership existed between Francis and Hazel Tower for federal income tax purposes, considering Hazel's lack of services and the source of her capital contribution.

Holding

1. No, because Francis Tower did not relinquish sufficient control over the gifted stock; the gift was conditional and intended solely to facilitate the partnership formation for tax avoidance.

2. No, because Hazel Tower did not contribute capital originating from herself or provide services to the partnership; therefore, the partnership was not bona fide for tax purposes, and the income attributed to Hazel was taxable to Francis.

Court's Reasoning

The court applied a rigid scrutiny to transactions between husband and wife designed to minimize taxes, noting "the temptation to escape the higher surtax brackets by an apportionment of income inside the family is a strong one."

The court found the gift of stock was not bona fide because Francis did not intend to irrevocably divest himself of control. Hazel's control over the stock was restricted; it was understood the stock's value would be reinvested into the partnership.

The court emphasized that a valid gift requires the donor to absolutely and irrevocably divest themselves of title, dominion, and control. Here, the conditional nature of the gift and Hazel's limited control indicated the absence of a bona fide gift.

The court distinguished the situation from legitimate tax minimization, stating, "Despite such purpose, the question is always whether the transaction under scrutiny is in reality what it appears to be in form." In this case, the form of a partnership did not reflect the substance, as Hazel was not a true partner in the business.

The court highlighted that the partnership served no business purpose other than tax savings. The business operations, management, and capital remained essentially unchanged.

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Referencing prior cases, the court reiterated that taxation is a practical matter focused on taxing income to those who earn it or create the right to receive it. Hazel did not earn the income; it was generated by Francis's business.

The court concluded that Hazel's role was based on her marital relationship, not on a genuine contribution to the partnership, thus failing to constitute a bona fide partnership for tax purposes.

Practical Implications

Tower v. Commissioner established a crucial precedent for evaluating family partnerships, particularly concerning income splitting for tax advantages.

This case emphasizes that for a family partnership to be recognized for tax purposes, each partner must contribute either capital originating from themselves or provide substantial services to the business.

It highlights the importance of demonstrating a bona fide intent to form a real business partnership, not merely a tax avoidance scheme.

Legal practitioners must advise clients that simply gifting assets to a family member who then becomes a partner is insufficient to shift income if the family member contributes no services and the capital is essentially derived from the controlling family member.

Subsequent cases have consistently applied the principles of *Tower*, focusing on whether the purported partner exercises real control over their capital and contributes meaningfully to the partnership's operations. This case remains a cornerstone in tax law regarding family partnerships and the scrutiny of intra-family income allocation.

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