3 T.C. 799 (1944)

A wife can be a bona fide partner in a family business for income tax purposes, even if she contributes no services, provided she owns a capital interest in the partnership and the partnership is formed in good faith for business purposes.

Summary

The petitioner, J.D. Johnston, Jr., sought to avoid income tax on profits allocated to his wife from a family partnership. Johnston transferred a partnership interest to his wife in exchange for a promissory note, and a new partnership was formed including his wife, himself, and the Johnston Oil Co. The Tax Court held that Johnston's wife was a bona fide partner for income tax purposes. The court reasoned that she had acquired a capital interest in the partnership, the partnership was recognized by other partners, and there was no evidence proving the arrangement was solely for tax avoidance. Therefore, the wife's share of partnership income was not taxable to the husband.

Facts

J.D. Johnston, Jr. and his father operated a peanut butter business as partners. Johnston offered to sell his share to family members, but his wife, Camilla, offered to buy it. A new partnership agreement was formed on April 1, 1938, including J.D. Johnston, Jr., Camilla Johnston, and Johnston Oil Co. Camilla purchased her 25% interest in the old partnership from her husband with a promissory note, intending to pay it from partnership profits. The new partnership assumed the assets and liabilities of the old one. Camilla had no business experience and provided no services to the partnership. Partnership books reflected Camilla's capital account and drawing account. She was authorized to and did write checks on the partnership account.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in J.D. Johnston, Jr.'s income tax for 1938 and 1939, arguing that income allocated to his wife from the partnership should be taxed to him. The United States Tax Court reviewed the case.

Issue(s)

1. Whether Camilla Tatum Johnston was a bona fide partner in J.D. Johnston, Jr. Co. for federal income tax purposes.
2. Whether the income attributed to Camilla Tatum Johnston from the partnership was taxable to her husband, J.D. Johnston, Jr.

Holding

1. Yes, Camilla Tatum Johnston was a bona fide partner.

2. No, the income attributed to Camilla Tatum Johnston was not taxable to her husband, J.D. Johnston, Jr., because she was a bona fide partner.

Court's Reasoning

The Tax Court emphasized that under Alabama law, spouses could be partners. The court found that Camilla acquired a capital interest in the partnership through a note, which was intended to be paid from her share of profits. The other partners consented to her inclusion and recognized her as a partner. The court noted, "Where a wife owns a capital interest in the partnership it is immaterial that the wife contributed no services to the firm." The court distinguished cases cited by the Commissioner where income was attributed to the husband because those involved personal service businesses dependent on the husband's efforts. Here, the income was derived from capital and the efforts of multiple family members, not solely J.D. Johnston, Jr. The court concluded that the partnership was a "bona fide association of persons to carry on business as a partnership" and Camilla's income was "an attribute of and flowed from her capital interest in the business rather than from the efforts and energy expended by petitioner."

Practical Implications

Johnston v. Commissioner clarifies that a wife can be a legitimate partner in a family business for tax purposes, even without providing services, if she genuinely owns a capital interest. This case is significant for family business planning, particularly in jurisdictions recognizing spousal partnerships. It emphasizes that the critical factor is the bona fide nature of the partnership and the wife's capital contribution, not her direct service to the business. Later cases distinguish *Johnston* based on the genuineness of the capital contribution and the level of control exercised by the husband over the wife's purported share of partnership income. The case highlights the importance of proper documentation and accounting practices to support the existence of a bona fide partnership.

