Scherer v. Commissioner, 3 T.C. 705 (1944)

A valid partnership can be formed between family members, even minor children, for tax purposes if there is a bona fide gift of capital interest and a real intent to form a partnership, and the income is taxed to the owners of the capital.

Summary

Robert Scherer made gifts of interests in his business to his wife and minor children and subsequently formed a partnership with them. The Commissioner argued that the entire income of the partnership should be taxed to Scherer due to his control over the business. The Tax Court held that valid gifts were made, a valid partnership was formed, and thus the income should be taxed to each partner based on their ownership interest, not solely to Scherer. The court emphasized that tax liability follows ownership of the property producing the income.

Facts

Robert P. Scherer owned a business, Gelatin Products Co., as a sole proprietorship. On June 30, 1937, Scherer made gifts of a one-sixth interest each to his wife and three minor children. Subsequently, a partnership agreement was executed between Scherer and his wife, acting individually and as trustee for their children. The partnership agreement designated Scherer as the managing partner with significant control over business operations and distributions. The Commissioner challenged the validity of these transactions, asserting that the entire partnership income should be taxed to Scherer.

Procedural History

The Commissioner determined deficiencies in Scherer's gift tax for 1937 and 1939 and income tax for 1938 and 1939. Scherer petitioned the Tax Court for redetermination. The Tax Court consolidated the cases. The Commissioner argued for increased valuation of the gifts and disallowance of gift tax exclusions and further argued that Scherer should be taxed on the entire partnership income. The Tax Court ruled against the Commissioner's determination regarding income tax liability.

Issue(s)

1. Whether the gifts in trust to the children were gifts of future interests, precluding the $5,000 statutory exclusions for gift tax purposes?
2. Whether the entire income of the Gelatin Products Co. for the fiscal years ended June 30, 1938, and June 30, 1939, is taxable to Scherer, despite his completed gifts to his wife and children?

Holding

1. Yes, because the beneficiaries were not entitled to the enjoyment of either the principal or the income unless and until they became twenty-five, or in the discretion of the trustee, they became twenty-one.
2. No, because valid gifts of capital interests were made, and a valid partnership was formed; therefore, the income is taxable to the individual partners based on their respective ownership interests.

Court's Reasoning

The Tax Court found that the gifts to the children were gifts of future interests, precluding the gift tax exclusion. Regarding the income tax issue, the court acknowledged the line of cases preventing personal service income from being assigned through family partnerships. However, the court distinguished this case, emphasizing that Scherer made valid, completed gifts of capital interests in a manufacturing business, not merely assigning personal service income. The court reasoned that because valid gifts were made and a valid partnership was formed, the income should be taxed based on ownership, not control. The court cited Justin Potter, 47 B.T.A. 607, where it held that "tax liability on income attaches to ownership of the property producing the income." The court rejected the Commissioner's argument that Helvering v. Clifford, 309 U.S. 331, should apply, finding that Scherer did not retain such control over the gifted interests as to warrant taxing the entire income to him. The court stated, "We do not feel that it is our function to change what we regard as existing law by an unwarranted extension of the doctrine of Helvering v. Clifford."

Practical Implications

This case clarifies that family partnerships can be valid for tax purposes, even with minor children as partners, provided there are bona fide gifts of capital interests and a genuine intent to form a partnership. The decision emphasizes that tax liability follows ownership of income-producing property. Attorneys must ensure that gifts are complete and irrevocable and that the partnership is operated in a manner consistent with its stated terms. Later cases have distinguished Scherer by focusing on whether the donor retained significant control over the gifted property, effectively negating the transfer. This case highlights the importance of establishing the economic reality of the partnership to avoid having the income reallocated to the donor.