5 T.C. 116 (1945)

A family partnership is recognized for tax purposes when the transfer of property interests is real, the partnership alters control of the business, and the purported partner has a substantial separate estate and assumes genuine liability for the business's losses.

Summary

Davis B. Thornton sought review of the Commissioner of Internal Revenue's assessment of deficiencies in his income tax for 1940 and 1941. The Commissioner argued that the income from a business operated as a partnership between Thornton and his wife should be taxed entirely to Thornton, asserting the partnership was not bona fide. The Tax Court held that the partnership was valid for tax purposes because Thornton's wife had a real ownership interest, significant separate assets, and genuine liability, distinguishing the case from situations where the purported partner had no real control or risk.

Facts

Davis B. Thornton initially operated a business as a corporation (Cromer & Thornton, Inc.). To buy out a litigious co-owner, Thornton borrowed money, and his wife, Lucy, hypothecated her insurance policies to secure part of the loan. Thornton gifted his wife 10 shares of the corporate stock and, later, an additional 115 shares. Following these gifts, the corporation was dissolved, its assets distributed equally to Thornton and his wife, and a formal partnership agreement was executed. Lucy had a substantial separate estate. Thornton managed the business, while Lucy provided no direct services. The Commissioner challenged the validity of the partnership, arguing that it was a scheme to avoid taxes.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Davis B. Thornton's income tax for the years 1940 and 1941, attributing all partnership income to Thornton. Thornton petitioned the Tax Court for review, contesting the Commissioner's assessment. The Tax Court ruled in favor of Thornton regarding the partnership income for 1941 but upheld the Commissioner's valuation regarding capital gains from the liquidation of the corporation, which led to the partnership.

Issue(s)

1. Whether the partnership between Davis B. Thornton and his wife, Lucy Bagley Thornton, should be recognized for federal income tax purposes, such that the partnership income is not entirely taxable to Davis B. Thornton.
2. Whether the Commissioner correctly determined the capital gain realized by Davis B. Thornton from the liquidation of D. B. Thornton Co., a corporation, in 1941.

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Holding

1. Yes, because the gift of stock to Thornton's wife was unconditional and irrevocable, giving her a real ownership interest in the business, and the partnership agreement granted her equal control and liability for losses.
2. The court upheld the Commissioner's calculation regarding the valuation of properties received in liquidation, since the petitioner provided no evidence to the contrary, and used a cost basis as agreed to by the petitioner.

Court's Reasoning

The Tax Court distinguished this case from others where family partnerships were disregarded for tax purposes. The court emphasized that Lucy Thornton had a substantial separate estate, was liable for the partnership's debts, and had equal control over the business under the partnership agreement. The court noted that the gifts of stock to Lucy were unconditional and irrevocable, giving her a genuine ownership interest. The court stated, "We have here a gift of corporate stock, fully effectuated. The petitioner's income from such stock was divided by the gift, not by the partnership." The court acknowledged that a motive for forming the partnership was to save taxes, but held that this motive alone did not invalidate the partnership if it was otherwise real. Judge Sternhagen dissented, arguing that despite the technical correctness of the forms adopted, the conduct of the business was unchanged, and the Commissioner's refusal to recognize the partnership should be sustained, citing *Higgins v. Smith, 308 U.S. 473*.

Practical Implications

Thornton v. Commissioner clarifies the requirements for a family partnership to be recognized for tax purposes. It emphasizes the importance of demonstrating a genuine transfer of ownership and control to the purported partner. The case suggests that a valid family partnership requires more than just a formal agreement; the partner must have real assets at risk and actual participation, or the right to participate, in the control of the business. This case informs how legal professionals should advise clients on structuring family-owned businesses to ensure that they meet the criteria for partnership recognition under tax law. Later cases distinguish *Thornton* by scrutinizing whether the purported partner truly shares in the risks and rewards of the business, emphasizing the need for economic substance over mere form.

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