Scherf v. Commissioner, 7 T.C. 362 (1946)

For federal income tax purposes, a family partnership is not recognized if the family members contributed no capital originating with them, had no voice in management or control, and contributed no vital services to the business.

Summary

John G. Scherf and George H. Barnes challenged the Commissioner's assessment, arguing that a valid partnership existed between them and their children. The Tax Court held that the partnership formed between Scherf, Barnes, and their children was not a bona fide partnership for federal income tax purposes because the children did not contribute capital originating with them, had no significant role in management, and provided no vital services to the business. Therefore, the entire income was taxable to Scherf and Barnes.

Facts

John G. Scherf and George H. Barnes operated the S & B Manufacturing Co. as equal partners. On May 16, 1940, they formed a partnership with their children: Paul W. Scherf, John G. Scherf, Jr., Mildred E. Barnes, and Ruth E. Barnes. Each child received a one-sixth interest in the business as a gift from their respective fathers. The partnership agreement designated Scherf and Barnes as managing partners and the children as investing partners. Scherf controlled office and financial matters, while Barnes managed manufacturing and factory operations. The children contributed minimal capital, had no real management authority, and their services were limited or negligible.

Procedural History

The Commissioner of Internal Revenue determined that the entire net income of S & B Manufacturing Co. was taxable to John G. Scherf and George H. Barnes. Scherf and Barnes petitioned the Tax Court for a redetermination, arguing that the income should be divided according to the partnership agreement. The Tax Court upheld the Commissioner's determination.

Issue(s)

Whether the partnership formed by John G. Scherf, George H. Barnes, and their children on May 16, 1940, should be recognized for federal income tax purposes, allowing the income to be taxed according to the partnership agreement, or whether the entire income is taxable to Scherf and Barnes.

Holding

No, because the children contributed no capital originating with them, had no voice in the management or control of the business, and contributed no vital services;

© 2025 SCOTUSreports.com. All rights reserved.

therefore, no bona fide partnership existed for federal income tax purposes.

Court’s Reasoning

The Tax Court relied on *Commissioner v. Tower, 327 U.S. 280*, which established that the critical question is who earned the income, which hinges on whether the parties genuinely intended to conduct business as partners. The court found that the children’s contributions were nominal. Their capital originated as gifts from their fathers. The partnership agreement explicitly limited their management role. Their services were either clerical (for the minor children) or aimed at learning the business (for Paul W. Scherf). The court emphasized that the services must be “vital” to the business’s income production to be considered a factor in recognizing a partnership for tax purposes. Since the children’s contributions were not vital, the court concluded that there was no genuine partnership for federal income tax purposes. The court stated, “[W]e are not concerned with whether the Scherf and Barnes children were the legal owners under the laws of Alabama of a one-sixth interest each in the capital of the business, for the issue for Federal income tax purposes is, Who earned the income?”

Practical Implications

This case reinforces the principle that simply creating a legal partnership with family members does not automatically shift income tax liability. It emphasizes that the IRS and courts will scrutinize family partnerships, particularly those involving gifts of capital and limited participation by family members. The key factors considered are the origin of capital contributions, the extent of management control exercised by each partner, and the importance of each partner’s services to the business. Tax advisors must counsel clients that for a family partnership to be respected for tax purposes, family members must genuinely contribute capital, labor, or management expertise. Later cases often cite *Scherf* and *Tower* when analyzing the validity of family-owned businesses as legitimate partnerships for tax purposes, especially where income-shifting appears to be the primary motive.

© 2025 SCOTUSreports.com. All rights reserved.