T.C. Memo. 1949-240

A transfer of partnership interest to family members may be subject to gift tax to the extent the assigned share of partnership earnings exceeds the value of their services and originates from business assets like goodwill, indicating a donative intent rather than an arm's-length transaction.

Summary

Eckert transferred interests in his soap business partnership to his relatives. The Commissioner argued this was subject to gift tax. The Tax Court held that to the extent the partnership earnings allocated to the new partners exceeded the value of their services and stemmed from business assets (like goodwill), the transfer constituted a gift. The court reasoned that the close family relationship suggested a lack of adequate consideration and a donative intent, making the transfer subject to gift tax to the extent of the excess value. However, the court waived penalties due to reliance on advice of counsel.

Facts

Petitioner Eckert operated a business specializing in 'Mazon' soap. He formed a partnership, assigning portions of the partnership to his relatives, the Eckerts. The partnership agreement stipulated Eckert retained the equivalent of all capital he contributed. The Eckerts received a 20% interest in the partnership earnings. Despite prior compensation of $20,000-$35,000 annually for their services, they received over $100,000 in the first year of the new partnership. The Commissioner determined a portion of the transfer constituted a gift subject to gift tax.

Procedural History

The Commissioner assessed a gift tax deficiency against Eckert. Eckert petitioned the Tax Court for review, contesting the gift tax assessment. The Tax Court upheld the Commissioner's determination that a gift had been made but waived the penalty for failure to file a timely gift tax return.

Issue(s)

Whether the transfer of partnership interests to family members constituted a gift subject to gift tax, to the extent the value of the transferred interest exceeded the value of services provided by the transferees.

Holding

Yes, because the share of partnership earnings assigned to the newly created partners exceeded the value of their services and originated from a business asset (goodwill), indicating a donative intent beyond an arm's-length transaction.

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Court’s Reasoning

The court reasoned that while contributions of personal services in a “vital” or managerial capacity can validate a partnership for income tax purposes, a business dependent on the activity of one partner cannot be used to shift tax liability to others with negligible contributions. If a capital contribution is the sole basis for partnership, it must originate with the new partner, not as a gift from the former proprietor. The court found that the critical asset of the business was the trade name, goodwill, and formula of “Mazon” soap. Because the close family relationship supports inferences of inadequate consideration and donative intent, the court found that the increased earnings flowing from the newly acquired interest in the business and its principal asset, unsupported by adequate consideration, constituted a gift. The court referenced the broad language of Section 1002 of the Internal Revenue Code which states “Where property is transferred for less than an adequate and full consideration in money or money’s worth…the amount by which the value of the property exceeded the value of the consideration shall…be deemed a gift…”

Practical Implications

This case emphasizes that simply structuring a transaction as a partnership does not automatically avoid gift tax implications when transferring value to family members. Courts will scrutinize the substance of the transfer, considering the source of the partnership earnings (capital vs. services), the value of the services provided by the new partners, and the presence of donative intent. Attorneys advising clients on family partnerships must carefully value the contributions of each partner, including both capital and services, to minimize the risk of gift tax liability. This ruling informs the analysis of similar cases by requiring careful consideration of goodwill as a transferable asset and the importance of demonstrating adequate consideration in intra-family business arrangements. Later cases may distinguish Eckert by demonstrating that the new partner’s contributions were commensurate with their share of profits or that the transfer occurred in the ordinary course of business.

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