Harkness v. Commissioner, T.C. Memo. 1958-4 (1958)

A family partnership is valid for tax purposes only if the parties, acting in good faith and with a business purpose, intend to presently join together in the conduct of the enterprise.

Summary

The Tax Court addressed whether a valid partnership existed between a father (Harkness, Sr.) and his children for tax purposes in 1943. Harkness, Sr. formed a partnership with his son and daughter, but the Commissioner argued it was not a bona fide partnership. The court held that no valid partnership existed because the children did not contribute substantial capital or vital services, nor did they participate in the management of the business. The court found the father retained control and the children's involvement was intended for the future, not the present.

Facts

Harkness, Sr., previously operated United Packing Co. as a sole proprietorship. In 1943, he formed a partnership with his son (Harkness, Jr.) and daughter (Harriet Colgate). Harkness, Jr. was in the Army since January 1942 and Harriet accompanied her husband, also in the Army, across the country. Neither child contributed substantial original capital. Harriet's share was acquired via a promissory note paid from company profits. Harkness Jr. used a small credit owed by his father and a promissory note paid from company earnings. The partnership agreement stipulated Harkness, Sr. would be the general manager in full charge of all operations and that the children would not devote any time to the business unless otherwise agreed. A supplementary agreement specified only Harkness, Sr. would receive compensation for services during the war.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies in the income tax liabilities of Harkness, Sr. and his wife. Harkness, Sr. and his wife petitioned the Tax Court for a redetermination, arguing a valid partnership existed. The Tax Court reviewed the case to determine whether the income from United Packing Co. should be taxed to the parents or recognized as partnership income distributed to all partners.

Issue(s)

Whether a bona fide partnership existed between Harkness, Sr., Harkness, Jr., and Harriet Colgate for the tax year 1943, such that the children's shares of the partnership income should be taxed to them rather than to Harkness, Sr. and his wife.

Holding

No, because the parties did not intend to presently join together in the conduct of the enterprise in 1943; the children did not contribute substantial capital or vital services, and Harkness, Sr. retained control of the business.

Court's Reasoning

The court relied on *Commissioner v. Culbertson*, 337 U.S. 733 (1949), stating the critical question is whether, considering all the facts, the parties intended to join together in the present conduct of the enterprise. The court found the purpose of forming the partnership was to secure the future services of the son and son-in-law after the war, not to obtain present contributions. The court emphasized the lack of substantial capital contribution from the children, citing *Lusthaus v. Commissioner*, 327 U.S. 293 (1946). The partnership agreement granted Harkness, Sr. complete control, contradicting an intent for the children to actively participate. The children's shares of the profits were also subject to Harkness, Sr.'s prior claims for payments he advanced and to pay off their promissory notes. The court quoted *Culbertson*: "The intent to provide money, goods, labor, or skill sometime in the future cannot meet the demands of §§ 11 and 22 (a) of the Code that he who presently earns the income through his own labor and skill and the utilization of his own capital be taxed therefor." The court concluded that the father continued to dominate the company and the children acquiesced in such control.

Practical Implications

This case illustrates the importance of demonstrating a present intent to operate a business as a genuine partnership, particularly in family partnerships. It highlights that merely shifting income to family members without genuine participation in the business or contribution of capital or services will not be recognized for tax purposes. The case emphasizes the need for careful documentation, including partnership agreements that reflect the actual roles and responsibilities of each partner. Later cases have cited Harkness to emphasize the importance of contemporaneous contributions and activities, not just future intentions, when assessing the validity of partnerships for tax purposes.

