T.C. Memo. 1947-46 (1947)

A family partnership will only be recognized for tax purposes if the parties involved genuinely intended to conduct the business together, considering factors like contributions of capital or services, control over income, and business purpose.

Summary

The Giffen case addressed whether a limited partnership formed between parents (the Giffens) and their four children should be recognized for tax purposes. The Tax Court held that the children were not bona fide partners because they did not contribute capital or services, nor did the parents genuinely intend to conduct the farming business in partnership with them. The court emphasized that income must be taxed to the one who earns it and found no business purpose for including the children, leading to the income being taxed to the parents.

Facts

Russell and Ruth Giffen operated a farming business. On October 14, 1941, they executed documents purporting to gift a portion of their farming property to each of their four children, contingent on a court order authorizing Ruth to accept the gifts and invest them in a limited partnership. The limited partnership, Russell Giffen & Co., was then formed. The children, as limited partners, did not contribute any services to the partnership. Russell Giffen, as the general partner, had complete control over the business and its assets. Net profits were only distributed to the children to cover their tax liabilities.

Procedural History

The Commissioner of Internal Revenue challenged the validity of the partnership for tax purposes, arguing that the children were not bona fide partners. The Tax Court reviewed the case to determine the validity of the partnership and the tax implications for the involved parties.

Issue(s)

1. Whether the Giffen children were bona fide partners in Russell Giffen & Co. for income tax purposes during the relevant period.
2. Whether any of the income of Russell Giffen & Co. was taxable to the children under Section 22(a) of the Internal Revenue Code as owners of capital invested in the partnership, even if they were not partners for tax purposes.
3. Whether the Commissioner erred in computing the Giffens' income based on the partnership's fiscal year rather than the calendar year used by the Giffens.

Holding

1. No, because the children did not contribute capital or services, and the parents

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did not genuinely intend to conduct the farming business in partnership with their children.
2. No, because the purported gifts of property interests to the children were incomplete, and the parents never relinquished control over the assets invested in the partnership.
3. No, because the partnership of Russell Giffen & Co. was still recognized for tax purposes between Russell and Ruth Giffen, even though the children's partnership status was not recognized; therefore, Section 188 of the Internal Revenue Code applied, allowing the income to be computed based on the partnership's fiscal year.

Court's Reasoning

The Tax Court applied the test from *Commissioner v. Culbertson*, emphasizing that the key question is whether the parties intended to join together in the present conduct of the enterprise. The court found that the children did not contribute independent capital or services. The purported gifts to the children were conditional and did not give them true ownership or control over the assets. Russell Giffen retained complete control, and the children's participation did not advance the business. The court stated, "To hold that individuals carrying on business in partnership include such persons would violate the first principles of income taxation that income must be taxed to him who earns it." The court also found no business purpose for including the children in the partnership, concluding that the parents were primarily motivated by tax benefits and a desire to eventually provide for their children. The court deemed the purported transfers incomplete and upheld the Commissioner's computation of income based on the partnership's fiscal year.

Practical Implications

The Giffen case illustrates the importance of demonstrating a genuine business purpose and real economic substance when forming family partnerships for tax purposes. It emphasizes that merely transferring income to family members without a corresponding transfer of control or contribution to the business will not be recognized for tax purposes. Later cases have used Giffen and Culbertson to scrutinize family business arrangements, requiring taxpayers to demonstrate that all partners genuinely contribute capital or services and actively participate in the business's management and control. The case serves as a warning against using partnerships solely for tax avoidance without a legitimate business purpose. It reinforces the principle that income is taxed to the one who earns it, and artificial arrangements designed to shift income to lower tax brackets will be closely examined by the IRS and the courts.

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