***Carriage Square, Inc. v. Commissioner, T.C. Memo. 1977-291***

For partnership tax purposes, income is allocated to the partners who genuinely contribute capital or services; when capital is not a material income-producing factor contributed by limited partners, and their participation lacks business purpose, partnership income can be reallocated to the general partner who bears the actual economic risk and provides services.

**Summary**

Carriage Square, Inc., acting as the general partner for Sonoma Development Company, contested the Commissioner's determination to allocate all of Sonoma's partnership income to Carriage Square. Sonoma was structured as a limited partnership with family trusts as limited partners. The Tax Court addressed whether these trusts were bona fide partners under Section 704(e)(1) of the Internal Revenue Code and whether capital was a material income-producing factor contributed by them. The court held that the trusts were not bona fide partners because their capital contribution was not material to the business's income generation, which heavily relied on loans guaranteed by the general partner's owner, and the trusts provided no services. Consequently, the court upheld the IRS's allocation of all partnership income to Carriage Square, Inc.

**Facts**

Arthur Condiotti owned 79.5% of Carriage Square, Inc. and several other corporations. Five trusts were purportedly established by Condiotti's mother for the benefit of Condiotti's wife and children, with nominal initial contributions of $1,000 each. Carriage Square, Inc. (general partner) and these trusts (limited partners) formed Sonoma Development Company to engage in real estate development. Sonoma's initial capital was minimal ($5,556 total). Sonoma financed its operations primarily through loans, which required personal guarantees from Condiotti. Sonoma contracted with Condiotti Enterprises, Inc., another company owned by Condiotti, for construction services. The limited partnership agreement allocated 90% of profits to the trusts and only 10% to Carriage Square, Inc., despite the trusts' limited liability and minimal capital contribution compared to the borrowed capital and Condiotti's guarantees.

**Procedural History**

Carriage Square, Inc. petitioned the Tax Court to challenge the Commissioner's notice of deficiency. The IRS had determined that all income reported by Sonoma Development Company should be attributed to Carriage Square, Inc. because the trusts were not bona fide partners for tax purposes. This case represents the Tax Court's memorandum opinion on the matter.

**Issue(s)**

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1. Whether the Form 872-A consent agreement validly extended the statute of limitations for assessment.
2. Whether the income earned by Sonoma Development Company should be included in Carriage Square, Inc.'s gross income under Section 61 of the Internal Revenue Code.

**Holding**

1. Yes, because Treasury Form 872-A, allowing for indefinite extension of the statute of limitations, is valid, and its use was reasonable in this case.
2. Yes, because the trusts were not bona fide partners in Sonoma Development Company, and capital was not a material income-producing factor contributed by the trusts; therefore, the income was properly allocable to Carriage Square, Inc.

**Court's Reasoning**

Regarding the statute of limitations, the court followed precedent in *McManus v. Commissioner*, holding that Form 872-A is valid for extending the limitations period indefinitely, as Section 6501(c)(4) does not mandate a definite extension period. On the partnership income issue, the court applied Section 704(e)(1), which recognizes a person as a partner if they own a capital interest in a partnership where capital is a material income-producing factor. However, the court found that "capital was not a material income-producing factor in Sonoma's business." The court reasoned that while Sonoma used substantial borrowed capital, this capital was secured by Condiotti's guarantees, not by the trusts' contributions or assets. Quoting from regulations, the court emphasized that for capital to be a material income-producing factor under Section 704(e)(1), it must be "contributed by the partners." The court noted, "Since Sonoma made a large profit with a very small total capital contribution from its partners and was able to borrow, and did borrow, substantially all of the capital which it employed in its business upon the condition that such loans were guaranteed by nonpartners…section 1.704-l(e)(l)(i), Income Tax Regs., prohibits the borrowed capital in the instant case from being considered as a 'material income-producing factor.'" Furthermore, applying *Commissioner v. Culbertson*, the court determined that the trusts and Carriage Square did not act with a genuine business purpose in forming the partnership. The trusts provided no services, bore limited liability, and their capital contribution was insignificant compared to their share of profits and the actual capital employed, which was secured by non-partner guarantees. Therefore, the trusts were not bona fide partners.

**Practical Implications**

*Carriage Square* clarifies the application of Section 704(e)(1) in partnerships, particularly regarding the "capital as a material income-producing factor" test and the determination of bona fide partners. It underscores that capital must be genuinely contributed by partners and be at risk in the business. Personal

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guarantees from non-partners to secure partnership debt can negate the characterization of borrowed funds as capital contributed by limited partners for tax purposes. This case is particularly relevant for structuring family partnerships or partnerships involving trusts as limited partners. It emphasizes the necessity of demonstrating a real business purpose and genuine economic substance behind the partnership arrangement, beyond mere tax benefits, especially where capital contributions and risk are disproportionate to profit allocations. Later cases applying *Culbertson* and Section 704(e) continue to scrutinize the economic reality and business purpose of partnerships, particularly those involving related parties or trusts, to ensure that profit allocations reflect genuine contributions of capital or services and economic risk.

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