Ketter v. Commissioner, 69 T. C. 36 (1977)

A partnership is not recognized for federal income tax purposes under Section 704(e) unless capital is a material income-producing factor and the partners truly own the partnership interests.

Summary

In Ketter v. Commissioner, the Tax Court ruled that a partnership formed by trusts established by Melvin P. Ketter was not valid for federal income tax purposes. Ketter, a CPA, created eight trusts which then formed a partnership to provide accounting services. The court found that the partnership's income was primarily derived from personal services, not capital, and that Ketter retained control over the partnership, failing to prove the trusts owned the partnership interests. This case underscores the importance of demonstrating that capital significantly contributes to income and that partners have genuine ownership and control in family partnerships for tax recognition.

Facts

Melvin P. Ketter, a certified public accountant, established eight irrevocable trusts in 1968 for his six minor children and his alma mater, St. Benedict's College. These trusts formed a partnership named "Melvin P. Ketter, C. P. A. ," despite Ketter not being a partner. The partnership received income from services provided to Ketter's accounting firm as an independent contractor. Ketter assigned "work in progress" and employment contracts to the trusts, which were then reassigned to the partnership. The partnership operated with 16 to 30 employees and used equipment with a book value ranging from $6,400 to $27,500. Ketter managed the partnership's operations, while the trustee, Donald J. Gawatz, devoted only about 14 hours annually to the partnership's affairs.

Procedural History

The IRS determined deficiencies in Ketter's federal income tax for the years 1968-1970, asserting that the partnership should not be recognized for tax purposes. Ketter petitioned the Tax Court to challenge these deficiencies. The Tax Court, in a decision by Judge Wilbur, ruled in favor of the Commissioner, holding that the partnership did not meet the requirements of Section 704(e).

Issue(s)

1. Whether the partnership formed by the trusts should be recognized for federal income tax purposes under Section 704(e)(1), which requires that capital be a material income-producing factor.
2. Whether the trusts owned the partnership interests under Section 704(e)(1).

Holding

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1. No, because the partnership's income was primarily derived from personal services rather than capital, and Ketter failed to prove that capital was a material income-producing factor.
2. No, because Ketter retained actual dominion and control over the partnership, and the trusts did not truly own the partnership interests.

Court's Reasoning

The court analyzed whether the partnership met the criteria of Section 704(e)(1), which requires capital to be a material income-producing factor. The court found that the partnership's income was generated by personal services, not capital, as the partnership had no inventory and minimal equipment relative to its income. Ketter's argument that capital was necessary to cover operating expenses between the time services were rendered and payment received was rejected, as this need alone did not establish capital's materiality. The court distinguished this case from others where capital played a more significant role, such as Hartman v. Commissioner, where the partnership dealt in merchandise.

Regarding ownership, the court applied Section 1. 704-1(e)(2) of the Income Tax Regulations, which considers various factors to determine if a partner has real incidents of ownership. The court found that Ketter retained control over the partnership's operations and the source of its income, as he managed the partnership's daily affairs and controlled the flow of work through his separate accounting practice. The partnership's failure to hold itself out as a separate entity, using Ketter's name and not registering under the state's fictitious name statute, further supported the court's conclusion that the trusts did not truly own the partnership interests.

The court emphasized that family partnerships require close scrutiny due to the potential for paper arrangements that do not reflect reality, citing cases like Krause v. Commissioner and United States v. Ramos. The court concluded that Ketter's control over the partnership was inconsistent with the trusts' purported ownership.

Practical Implications

This decision has significant implications for tax planning involving family partnerships and the assignment of income. Practitioners should be aware that for a partnership to be recognized for tax purposes, it must demonstrate that capital is a material income-producing factor, particularly in service-based businesses. The case highlights the importance of ensuring that partners have genuine ownership and control, especially in family arrangements where the potential for control by the grantor is high.

Legal professionals advising clients on partnership structures must carefully consider the nature of the business and the role of capital in generating income. The decision also underscores the need for partnerships to be held out as separate

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entities to the public and to maintain clear distinctions in business operations.

Subsequent cases have applied and distinguished Ketter, reinforcing the principles that partnerships must be based on genuine economic arrangements and that the IRS will closely scrutinize family partnerships for compliance with Section 704(e). This case serves as a reminder of the challenges in shifting income through family partnerships and the importance of adhering to the substance-over-form doctrine in tax law.

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