



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal
of
FERN A, YARBROUGH and ZOLA R. YARBROUGH

Appearances:

For Appellant: Raleigh P. Nelson, Certified Public Accountant

For Respondent: John S. Warren, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on **the protests** of Fern A. Yarbrough and his wife, Zola R. Yarbrough, to proposed assessments of additional personal income taxes as follows:

| | | |
|-------------------|------|------------|
| Fern A. Yarbrough | 1944 | \$4,891.86 |
| Fern A. Yarbrough | 1945 | 4,910.82 |
| Zola R. Yarbrough | 1944 | 4,891.86 |
| Zola R. Yarbrough | 1945 | 4,910.82 |

The only question presented by this appeal is whether a family partnership composed of Appellant, Fern A. Yarbrough, his adult son, and his father-in-law should be recognized in the computation of State income taxes. The Respondent bases its proposed assessments upon the theory that the partnership was not bona fide but was used solely for **tax-saving** purposes and that earnings of the partnership in excess of Federal and State income taxes and reasonable compensation to Appellant's son and father-in-law actually accrued to Appellant. The Appellant contends the partnership was a bona fide partnership and should be recognized for tax purposes.

The Appellant, as a sole proprietor, began the manufacture and sale of microphones and related products in 1929 under the name of American Microphone Company. On January 1, 1932, the business was incorporated with Appellant taking **160** of the authorized **175 \$100.00** par value shares. The remaining 15 shares were issued to Peter S. Gramer, Appellant's **father-in-law**, for a cash consideration of **\$1,500.00**. Mr. Gramer served

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as president of the corporation but, being employed on a full time basis by another concern, he rendered only part time services to the corporation, His salary for these services was \$6,000.00 per annum during 1942 and 1943. Appellant served as vice-president and general manager, devoting full time to the business, Mr. F. G. Yarbrough, the son of Appellant, also worked full time for the business after his graduation from high school in 1933, His salary was \$13,710.00 in 1942 and \$17,025.48 in 1943.

On December 14, 1943, the Appellant sold a portion of his 160 shares in the corporation to his son and father-in-law. The son purchased 58 shares for a cash payment of \$1,000.00 and a note for \$16,418.86. Mr. Gramer purchased 43 shares, to add to the 15 he already owned, for a cash payment of \$1,000. and a note for \$14,918.86. Then on December 31, 1943, the corporation was liquidated and a partnership, composed of the three shareholders, was formed to continue the business.

The partnership agreement provided that the three partners were to share equally in the profits of the enterprise and were to have equal rights in the management and conduct of the partnership business. In the actual operations Appellant continued to act as general manager of the business; his son was in charge of purchasing and acted as general manager when Appellant was not present; his father-in-law continued to render part time services consisting of weekend guarding of the plant and the supervision of weekend operations if any happened to be in progress. All three partners signed checks and contracts and they consulted with each other regarding partnership affairs.

The earnings of the partnership for the years 1944 and 1945, the period of its existence, amounted to \$493,042.22. From these earnings the son drew, as salary, \$16,792.16 in 1944 and \$15,467.72 in 1945. The father-in-law drew \$6,000.00 each year as salary, Both also drew sufficient sums to pay their federal and state taxes, for 1944 and 1945, on a third of the partnership earnings. In addition to the above sums Mr. Gramer drew \$41,178.35 by check dated December 13, 1945, and Mr. F. G. Yarbrough drew 336,267.21 by check on the same date, These checks were endorsed by the payees and deposited in the Appellants' account on December 14, 1945. The only other withdrawals by the son and father-in-law were of \$6,500.00 and \$3,000.00, respectively, upon liquidation which occurred on December 31, 1945. The reasons given by Appellant for the dissolution were that the prospects of future profits were not good and a divorce action had been commenced by the wife of Mr. F. G. Yarbrough. Appellant

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continued doing business under the same name as a sole proprietor. His son continued to work for him but Mr. Gramer apparently retired and has since died.

The specific issue which we must decide is whether the above facts evidence a bona fide partnership for the years 1944 and 1945.

The leading cases in this area, cited by both parties in support of their contentions, are Commissioner v. Culbertson, 337 U.S. 733, 93 L. Ed. 1659 (1949); Commissioner v. Tower, 327 U.S. 280, 90 L. Ed. 670 (1946); and Lusthaus v. Commissioner, 327 U.S. 293, 90 L. Ed. 679 (1946). In the Culbertson decision, the latest of the three, the Court clarified the rules applicable to family partnerships and corrected what it felt were erroneous interpretations of the Tower and Lusthaus cases by the lower courts. The test it enunciated in that case is the one which is to be used in determining whether the facts set forth above evidence a bona fide partnership. That test is, Culbertson, supra, at p. 742: "whether, considering all the facts - the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent - the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. "

This test) of true intent, is, of course, primarily one of fact which explains how both parties can rely on the same authorities and yet reach contrary conclusions. Since this is a question of fact we must make our decision in the light of the facts presented by this appeal pertaining to the agreement of the Appellant, his son, and father-in-law and their conduct in the execution of its provisions. The Appellant argues that because there was a formal agreement, because there was a contribution of capital, because the other participants also contributed vital services in an executive capacity and because they had equal rights to control and manage the business, this was a bona fide partnership and must be recognized as such by this Board.

Even though Appellant's statement of each of these facts, on which he rests his case, be accepted, the facts themselves point to an absence of a bona fide intent upon the part of the participants to join together as partners in the conduct of this business. Because of the obvious

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possibilities of tax avoidance which a family partnership affords, it must be closely but fairly scrutinized. Bruce W. Hulbert, ¶54,007 P-H Memo TC (1953), aff'd. in 227 F. 2d 399 (7th Cir., 1955). We have given this family partnership a fair and objective but close examination and having done so we find lacking the necessary intent to create a true partnership. We so find for two reasons,

First, because the motivating force behind the formation of the partnership appears to us to be **solely** that of tax saving, At a hearing before the Franchise Tax Board when asked the purpose for selling the stock in the corporation to the son and father-in-law, the Appellant answered, "Help and taxes? Inasmuch as the sale of the stock was the initial step in the series resulting in the formation of the partnership, it would appear that the purpose which impelled the Appellant to take this step is the motivating factor in the **entire** transaction. Moreover, it is apparent that the real object was tax-saving while the other reason was asserted without any factual substantiation. Although Appellant argues that by this method he secured the executive service of the **other** participants, the facts show that these abilities were available to him and used in the business prior to **December** of 1943 and, except for Mr. Cramer, who guarded the plant on weekends, were **available after the** partnership was **dissolved**. Furthermore, the record shows that the arrangement was changed as soon as the tax **benefits** ceased. It is significant that this arrangement was utilized only during the period of large profits on war contracts, After these contracts were terminated the partnership was liquidated and Appellant again operated as a sole proprietor, As Judge Yankwich said in another family partnership case, Schlobohm v. U.S., 105 F. Supp. 593, 595 (D.C. S.D. Cal., 1952) "In the circumstances the partnership was a device initiated to **achieve a single result**, a reduction of taxation, and was given the coup de grace the moment it became apparent that that **result could not be** achieved. So the situation is of the type that has been repeatedly denied **judicial sanction.**" We find that this partnership was organized **solely** to save taxes. And while it is true that men may **so** arrange their affairs as to **incur the least possible tax liability**, still in the family partnership area motive has been made a test of tax liability when the reduction of taxes is the sole motive, See Dyer v. Commissioner, 211 F. 2d 500 (2nd Cir., 1954).

The second reason for our **finding** that a bona fide intent to join together as partners **is lacking** is that the partnership did not **effect any change** in the economic or financial status of the participants, In the Culbertson

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case, supra, the Court said, at p. 745, "In the Tower and Lusthaus Cases this Court ... found that the purported gift whether or not technically complete, had made no substantial change in the economic relation of members of the family to the income... We characterized the results of the transaction entered into between husband and wife as 'a mere paper reallocation of income among the family members' noting that 'The actualities of their relation to the income did not change,' 327 U.S. at 292. This, we thought, provided ample grounds for the finding that no true partnership was intended..." The facts of this case also disclose that the actualities of the relation of the participants to the income did not change. The withdrawals of the son and father-in-law (leaving the checks of December 13, 1945, aside for the moment) were only of amounts sufficient to give them a net annual increase in personal wealth equivalent to the sums received annually prior to the formation of the partnership. Appellant apparently concedes this would be so but for the payments of December 13, 1945, which he alleges show they received the share of income they were entitled to under the agreement. He asserts that the fact that he deposited these checks in his own account the next day is not pertinent to the issue presented on this appeal as the checks then represented loans to Appellant by the others which were to be repaid at some future date. We are unable to accept this contention inasmuch as no evidence of the indebtedness was shown and it was brought out at the hearing that Mr. Cramer's estate had not listed this "loan" as an asset of the estate. In the light of these facts we can find only that the result of the transactions involved here was to effect a mere paper reallocation of income without effecting any real change in the economic or financial status of the participants and this finding is, in the words of the Supreme Court quoted above, "ample grounds for the finding that no true partnership was intended."

It is our conclusion that Appellants have failed to show the existence of a bona fide partnership and the action of the Franchise Tax Board must, therefore, be sustained.

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O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to Section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Fern A. Yarbrough and Zola R. Yarbrough to proposed assessments of additional personal income taxes in the amounts of \$4,891.86 and \$4,910.82 against Fern A. Yarbrough for the years 1944 and 1945, respectively, and in the amounts of \$4,891.86 and \$4,910.82 against Zola R. Yarbrough for the years 1944 and 1945, respectively, be and the same is hereby sustained,

Done at Los Angeles, California, this 23rd day of October, 1956, by the State Board of Equalization,

Paul R. Leake, Chairman

Robert E. McDavid, Member

J. H. Quinn, Member

George R. Reilly, Member

Robert C. Kirkwood, Member

ATTEST: Dixwell L. Pierce, Secretary