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TRUST PARTICIPATION IN A PARTNERSHIP

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The Case and the Holding

In *Hanson* v. *Birmingham,* 92 F. Supp. 33, the settlor-trustee-taxpayer sought the refund of taxes paid by him on income that he asserts should have been charged to the trust. Taxpayer contended that the trust *res* was the partnership member, and that consequently the income should have been assessed to it. The commissioner's position was that a trust *res,* due to a lack of legal capacity, is incapable of being a partner; that taxpayer, and not the trust, was the partner; and that therefore the income was correctly assessed to taxpayer. The issue was, "To what legal entity was this portion of the partnership income taxable?"

The court resolved the dispute in the commissioner's favor holding ". . . the . . . trust was not a valid member of the partnership for federal income tax purposes. The holding . . . is determinative of the entire case."

The Dicta in the Decision

In the decision rendered on July 29, 1950, Judge Graven, speaking for the United States District Court for the Northern District of Iowa, stated by way of dicta that a trust cannot be a valid member of a partnership for federal income tax purposes. It was stipulated that the court used the word trust to denote the trust property, trust estate, or trust subject matter itself; and not to denote the fiduciary relationship created, or the trustee, or the trust beneficiaries.

If the court's holding were based on the incapacity of the trust (using trust to mean the trust subject matter) to be a valid member of a common law partnership because the trust in that sense is not recognized at law as a distinct legal entity with legal capacity, and if the court confined itself to such statements, there would be a strong argument available to maintain its position. That argument would be that to participate in a partnership it is essential for the person so wishing to participate to have legal capacity; that the subject matter of a trust has no legal capacity, and consequently cannot possibly become a valid member of a partnership. Such an argument must be conceded to have merit. However, the court neither appeared to base its holding and statements upon that argument, nor did it limit its discussion to this objection to the participation of a trust in a partnership.

The court, instead, proceeded to discuss at length what it considered the insurmountable problem of the fundamentally different legal features of these two relationships (trust and partnership).

The court spoke particularly of the agent-principal and principal-agent relationship existent among partners, and then of the inability of a trust to act other than through the medium of its trustee and his properly appointed agents, and the stringently restricted ability of trustees to properly delegate the exercise of their powers, as trustees, to others—that trustees can properly delegate their authority to others only when a reasonably prudent business man, in the conduct of similar business, would employ agents or servants. At the conclusion of these considerations the court stated that, in its view, there is an irreconcilable inconsistency between these two relationships, and that neither under the common law, nor under the present law of Iowa (Iowa has not adopted the Uniform Partnership Act, but has adopted the Uniform Limited Partnership Act) does a trust have the legal qualifications necessary to become a valid member of a partnership. The court's wording was

> "It is the view of the court that under the common law a trust does not have the legal capacity to become a member of a partnership and that the same is true under the Iowa law. Therefore, if there is such a thing as a trust partner, it is peculiar to and indigenous to that field of law which might be termed the Internal Revenue Code field of law and it exists in that field and in no other field."

The court then proceeded to find that for federal income tax purposes a partnership is no different than a partnership for any other purpose, ergo it is the equivalent of a common law partnership. The court cited in support of this position Justice Frankfurter's concurring opinion in *Commissioner of Internal Revenue* v. *Culbertson,* 337 U. S. 733, and the law review article so interpreting that opinion written by Judson A. Crane, Dean Emeritus of the University of Pittsburgh Law School and a well-known writer in the field of partnership law.

The court's view is, therefore, to be interpreted to mean that a trust cannot, for any purpose, participate in a partnership.

The purpose of this article is to dispute the soundness of this doctrine because it is believed that a trust can participate in a partnership.

An Examination of the Problem

There are two main questions invloved, namely: Is an interest in a partnership a property interest which can be held in trust? Can a trustee in his personal capacity or as a representative be a partner?

The law of trusts postulates that any property which is recognized as valuable by a court of equity, whether legal or equitable, real or personal, so long as it is certain, can be the subject matter of a trust. An interest in a partnership is the right to share in the partnership profits and an undivided interest in the realty and personalty owned by the group. An undivided interest has often been sanctioned as a trust *res,* and there would seem no difficulty from the point of view of property law in permitting it to be the trust *res.*

It must be agreed that neither the trust subject matter, nor the intangible fiduciary relationship, can be the partner, because both lack legal personality. In most situations it would not be intended that the beneficiaries of the trust should become the partners. Assuming that the trustee will be the partner, the further question is whether the trustee is partner as John Doe (in an individual capacity) or as John Doe, as trustee (in a representative capacity). It would seem that either one of these entities could be made a partner by proper provisions in the partnership articles, and that normally it would be desirable to have John Doe as trustee be a partner, so as to free the individual property of Doe from control by the co-partners, as among the partners. However, it seems most valuable to discuss the problem here upon the supposition that the trustee becomes a partner in his individual capacity. This is because the law does not generally recognize the trustee in his representative capacity as a distinct legal entity. The trustee would be a partner, under a duty, enforceable in equity, to conduct himself in his position as a partner in a manner calculated to render the greatest benefit to the trust beneficiaries. The trustee-partner could pursue this course of action without finding himself in the position of trying to serve conflicting interests because any act which would serve the trust would also serve the partnership and vice versa.

The court in the Hanson case stated that it was "fundamentally alien" to the normal functions of an executor or an administrator for him to carry on a partnership business; however, this is commonly done with court approval where the will so directs. The court promulgated the general common-law rule as being that a corporation cannot become a partner because the agent-principal and principal-agent relationship of partners is inconsistent with control and management of the corporation by its officers and shareholders. Notwithstanding this, the Uniform Partnership Act (in force in 27 states) would seem to allow a corporation to become a partner by defining a "person" as including individuals, partnerships, corporations, and associations (Uniform Partnership Act, sec. 2) and defining a partnership thusly: "A partnership is an association of two or more persons to carry on as co-owners a business for profit." (U. P. A., sec. 6-1.) In support of this view, there is authority for corporations to be considered partners where their charters authorize such and the partnership participated in was one engaged in a business conforming to the corporate purposes (14 Minn. Law Review 769; Crane on Partnerships, sec. 9). This problem is largely one of the law of corporations, and its solution dependent on the provisions of the corporate charter. The court argued through the analogy of a trustee to an executor or administrator and of a trust to a corporation, that neither a trustee, nor a trust, is qualified to participate in a partnership. This line of argument seems patently unsound, and sufficiently refuted by the foregoing observations plus the fact that the executor-administrator and trustee and corporation and trust analogies are not particularly accurate. Additionally, a person should not be precluded from becoming a member of a partnership in his personal interest merely because he is a trustee.

The Mutual Agency—Inability to Delegate Aspect of the Problem

This writer does not concur in the view that the mutual agency relationship existent in a partnership, and the limited ability of a trustee to delegate his powers should prevent a trust from participating in a partnership.

One mode of operation would be to have the trustee become a limited or special partner in the partnership with no powers of management and with liabilities limited to those assets in the hands of the partnership at the trust's inception. The trustee would not be liable for this loss, should it result, because he would be in no way responsible for the investment, and by express statement in the trust instrument would have been authorized to continue it. Cases specifically recognizing such a relationship as proper are: *In re Marcuse and Company,* 263 U. S. 553; *Crehan* v. *McGargle,* 234 N. Y. 67; and *Stern,* 15 Tax Court, number 71.

Another scheme, particularly feasible in the case of a family partnership, which is where this type of problem most often arises, would be to designate all the partners as the trustees. The problem of the ability of the partners to act for the trust would be solved, and the additional problem of the requirement that joint trustees act in unison could be solved by having the important, as contrasted to mere ministerial, partnership business carried on only by unanimous decisions. This latter policy would somewhat drastically curtail the conveniences attendant on the ability of the partners to act as mutual agents, and could not be insisted upon by any partner or by the partnership articles, but in a family partnership it should be a procedure easily effectuated by common consent. An alternative arrangement would be the designation of the trustee-partner by the partnership as the managing partner. This would solve not only the mutual-agency and inability-to-delegate problems, but also the acting in unison problem.

Even in the instance of a non-family partnership where the trustees and partners are not identical the difficulties do not seem so great that they cannot be overcome by judicious drafting of the trust instrument and the articles of partnership. While the articles of partnership cannot exempt any general partner from individual responsibility for partnership obligations when the partnership assets are insufficient to meet partnership liabilities, the articles can provide how such losses are to be borne among the partners themselves. Thus, the trustee-partner could be stated to be entitled to exoneration by, or indemnity from, the other partners for losses suffered by him, personally, by reason of his participation in the partnership on behalf of the trust. The trust indenture could be drawn to state that the trustee was liable for breaches of trust only when the same were committed by him in bad faith. Thus, for an improper delegation of authority (to a partner) and the accompanying technical breach of trust the trustee would not be liable except under the stipulated circumstances. Likewise it could be provided that the trustee was to have extraordinary rights over against the trust for liabilities incurred by him in his participation in the partnership in the interest of the trust beneficiaries. Obviously the trust instrument should direct that the trustee become a member in the partnership for the benefit of the trust. Terms such as these, if included in the trust document, would make the trustee's position relatively secure against his suffering personal losses.

Even if these proposed terms were not embodied in the trust instrument and partnership articles, it does not seem that it should be said that it is impossible for the trustee to become a member of a partnership for the benefit of the trust. Although such a course might be extremely unwise for the usual trustee because the result might be to subject him to liability to the beneficiaries for technical breaches of trust where damage to the beneficiaries could be shown, and possible subjection of the trustee to claims against him personally for liabilities incurred by the partnership with no right in him for a claim of reimbursement from the trust due to his own breach of trust (where another partner incurred the partnership obligation). The fact is, however, that when such a combination is contemplated there is not usually an ordinary trustee. Most often, as in the Hanson case, there is a trustee, who for some reason, generally that of close consanguinal relation to the beneficiaries, is willing to assume all these risks. An additional factor protecting the trustee would be that in such situations it would seem likely that there would be a reluctance to press claims against him. Even when it is conceded that there are many dangers inherent in assuming such a trusteeship, and that it might be exceedingly imprudent for a person to do so, this is not a reason for arguing the impossibility of the arrangement, but rather it goes merely to the advisability of the trustee's consent to act as such.

If a settlor desires and directs such a situation, it would seem that the beneficiaries would have no ground for complaint.

No rule in the law of partnerships would prohibit the trustee in his personal capacity from being a member of the partnership as a limited partner—nor is there any legal barrier to the partners all being made trustees of the trust, or the trustee-partner being the managing partner. Finally, there would be no objection to the third alternative of the trustee being a partner in the interest of the trust, if the other partners would be willing to accept him as such.

It is, of course, axiomatic that before the trustee could become a partner, under any arrangement, the consent of all the partners would have to be obtained.

In a family partnership consent would doubtlessly be a mere formality. In a non-family partnership the participation of the trustee as a partner would not be in any way detrimental to the firm if he were a man of personal wealth so as to be able to meet any obligation which might be assessed against him by reason of the firm's liabilities; and so, too, if the trustee possessed a right over against the trust for his liabilities arising from his participation in the partnership, because this right over would be available to the personal creditors of the trustee-partner who were his creditors due to his status as a partner.

Only where the trustee is not a man of private means, and where there is no right over against the trust, would the other partners hesitate to consent to his inclusion. The deterrent factor would be that his inclusion might be detrimental to the credit of the partnership. However, such a detrimental effect would occur only if those assessing the credit of the partnership did so not only on the basis of the financial solidarity of the partnership, but also on the financial standing of the individual partners. The likelihood of such an analysis by prospective clients is small, and even if it were made the total damaging effect on the partnership would probably not be great.

The consent problem is again one which goes, not to the possibility in law of the relationship, but only to the probability and advisability of creating it.

The effort to make an interest in a partnership trust property could be either by a declaration by a partner that he held all or part of his interest in the partnership in trust; or by an attempt to transfer to a third person as trustee a part or all of the partner's interest. In both cases it would seem that by such declaration or transfer the partnership would be terminated and that a new partnership would have to be formed. This would seem most prudent in order to allow the partnership articles to be redrawn as above suggested, but the new partnership might be created impliedly by the old partners going on in the business with the trustee.

While it is not contended that there are a great many situations where the establishment of such a relationship will be particularly valuable due to the risks assumed by the trustee and the non-trustee partners, it is suggested that there are problems which could be solved advantageously by this combining of partnership and trust. Specifically, this could be an extremely desirable arrangement to the settlor by enabling him to avoid excess profits taxes on his business profits (in switching to this type of partnership from a corporation), to reduce his personal income taxes, and by enabling him to give selected beneficiaries an interest in the business without giving them any control. The arrangement could also be used to provide for minor or incompetent children, while minimizing the tax burden. Where such a result is sought this solution should be available and carefully considered rather than too hastily precluded and discarded.

An Alternative Approach to Hanson v. Birmingham *And the Problem It Presents*

Another possible approach to the problem would be to consider the transaction in the Hanson case as the transfer to the trustee of only the settlor's right to income from the partnership, and not the transfer of the settlor's right to income and his position as tenant in partnership. Such a transfer would be, in law, a mere assignment to the trustee of the settlor's beneficial interest in the net income of the continuing partnership. This type of a transfer would be much less satisfactory to the beneficiaries and to the settlor because the income of the partnership assigned to the beneficiaries of the trust would continue to be assessed to the settlor for income tax purposes because he has merely assigned the "fruit" and has not transferred the "tree." Additionally, there would be the problem that on the settlor's death his retained interest in the partnership would have to be disposed of, and as it would be solely a burden, who would be willing to accept it without the normal advantages attached? The only practical disposition would be to transfer the interest to the trust, and then the problem previously discussed arises.

This treatment of the situation would perhaps be a satisfactory temporary expedient, but it would only result in postponing the eventual problem to the time of the settlor's death.

Conclusion

The writer is unable to explain the failure of the court to comment on the status of another trust, the Sigrid Hanson Trust, as a participant in the S. Hanson Lumber Company partnership. The suggestion is made that this could be due to the nature of the case, and the fact that this trust was not a party to the litigation. Another, though more remote, possibility is that the court's actual view does not go as far as some of its statements, loosely made in the course of the decision, might indicate.

It is concluded that, under the presently existent law of partnerships and of trusts, a trust can participate in a partnership with the trustee the partner in his individual capacity and under an equitable duty to the trust beneficiaries; and that the court in the Hanson case, insofar as it stated otherwise, overextended itself. (*Feldman* v. *Commissioner of Internal Revenue,* 186 F. 2d 87; *Stern,* 15 Tax Court number 71.)