7 T.C. 1258 (1946)

A husband-wife partnership will not be recognized for federal income tax purposes if it is determined that the arrangement is merely a superficial attempt to reduce income taxes without a genuine transfer of economic interest or control.

Summary

The petitioner, Greenberg, sought to recognize a partnership with his wife for income tax purposes to reduce his tax liability. He purported to "sell" his wife a one-half interest in his furniture business, funding her purchase with a gift and promissory notes. The Tax Court held that despite the legal formalities of a partnership agreement, the arrangement lacked economic substance, as the wife's contribution was derived directly from the husband's initial gift and business profits. Therefore, the court disregarded the partnership for federal income tax purposes, taxing all business profits to the husband.

Facts

In 1939, Greenberg anticipated large earnings from his furniture business and sought advice from his accountant to mitigate his tax liability. They devised a plan to create a partnership between Greenberg and his wife. Greenberg would "sell" his wife a one-half interest in the business. He would gift her a portion of the purchase price, taking promissory notes for the remainder. The wife would then pay off the notes from her share of the business profits. Greenberg borrowed money from the bank and withdrew cash from the business to facilitate the arrangement. An attorney was consulted to ensure the legal formalities were met.

Procedural History

The Commissioner of Internal Revenue determined that Greenberg was taxable on all the profits from his furniture business, disputing the validity of the partnership for tax purposes. Greenberg petitioned the Tax Court to challenge the Commissioner's determination. The Tax Court upheld the Commissioner's decision, finding the partnership lacked economic substance.

Issue(s)

1. Whether a husband-wife partnership should be recognized for federal income tax purposes when the wife's capital contribution originates from gifts and loans provided by the husband, and her participation in the business is minimal.

2. Whether the husband is entitled to claim the personal exemption that was claimed by his wife on her separate return.

Holding

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1. No, because the arrangement lacked economic substance and was primarily motivated by tax avoidance, with the wife's contribution being derived directly from the husband's initial gift and business profits.

2. No, because the wife claimed the exemption on her separate return and had not waived her claim to it.

Court's Reasoning

The court reasoned that the formalities of the partnership agreement and registration did not alter Greenberg's economic interest in the business. The wife acquired no separate interest because she merely returned the funds Greenberg had given her for the specific purpose of creating the partnership. The court emphasized that the wife's role in forming the partnership was minimal, stating she simply did what counsel advised. Drawing parallels to similar cases, the court cited *Schroder v. Commissioner*, emphasizing that the income was predominantly generated by Greenberg's services and capital investment. The court stated, "Whether or not the arrangement which petitioner made with his wife constituted a valid partnership under the laws of Pennsylvania, we do not think that it should be given recognition for Federal income tax purposes." Regarding the personal exemption, the court noted that the wife had already claimed the exemption on her separate return and had not waived it; therefore, Greenberg was not entitled to it.

Practical Implications

This case highlights the importance of demonstrating genuine economic substance when forming a husband-wife partnership for tax purposes. The ruling emphasizes that mere legal formalities are insufficient if the wife's capital contribution and participation are nominal and directly linked to the husband's assets or earnings. Later cases have applied similar scrutiny to family partnerships, requiring evidence of the wife's independent contribution, control, and economic risk. Attorneys must advise clients that husband-wife partnerships will be closely examined by the IRS and the courts, and that a genuine business purpose beyond tax avoidance is essential. This case serves as a cautionary tale against artificial arrangements designed solely to shift income and reduce tax liabilities.

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