Dubinsky v. Commissioner, 1947 Tax Ct. Memo LEXIS 140 (1947)

A taxpayer cannot avoid income tax liability by nominally creating a partnership with family members if the arrangement lacks economic substance and the taxpayer retains control over the business and income.

Summary

The Tax Court held that income credited to the taxpayer's wife, son, and daughter as "partners" in his business was taxable to the taxpayer because the purported partnerships lacked economic substance. The court found that the taxpayer retained control over the business, and the family members contributed no significant capital or services. The court also held that the assessment of deficiencies for 1938 and 1939 was not barred by the statute of limitations due to the taxpayer's omission of more than 25% of gross income and the execution of a waiver for 1938.

Facts

The taxpayer, Mr. Dubinsky, operated a business and credited profits to his wife, son, and daughter as partners based on operating agreements. The Commissioner of Internal Revenue determined these agreements were not bona fide partnerships and that the credited amounts were actually assignments of the taxpayer's income. The wife, son, and daughter purportedly became partners, but the business operations remained largely unchanged. The wife invested no capital originating from herself and did not contribute substantial services. Similar situations existed for the son and daughter.

Procedural History

The Commissioner assessed deficiencies against the taxpayer for the years 1938, 1939, 1940, and 1941, arguing the income credited to the family members was taxable to the taxpayer. The Tax Court reviewed the Commissioner's determination and the taxpayer's challenge to the assessment, including the statute of limitations issue for 1938 and 1939.

Issue(s)

1. Whether the operating agreements between the taxpayer and his wife, son, and daughter created valid and bona fide partnerships for income tax purposes.
2. Whether the assessment and collection of deficiencies for 1938 and 1939 were barred by the statute of limitations.

Holding

1. No, because the taxpayer and his family members did not intend to carry on business as a partnership, and the agreements did not materially change the operation of the business or the taxpayer's control. The arrangement was a mere

"paper reallocation of income among the family members."
2. No, because the taxpayer omitted more than 25% of gross income for 1939, triggering the five-year statute of limitations, and the taxpayer executed a waiver extending the limitations period for 1938.

Court's Reasoning

The court reasoned that the critical question is whether the parties intended to carry on business as a partnership. The court found that the taxpayer maintained control over the business and property after the agreements. The wife, son, and daughter did not invest capital originating with them or contribute substantially to the control or management of the business. Citing *Commissioner v. Tower, 327 U.S. 280 (1946)*, the court emphasized that state law treatment of partnerships is not controlling for federal income tax purposes. The court stated that giving leases and subleases to family members did not create a genuine partnership; the arrangement lacked economic substance. As to the statute of limitations, the court relied on Section 275(c) of the Revenue Act of 1938, which provides a five-year limitation period if the taxpayer omits more than 25% of gross income. The court found this applied to 1939. For 1938, the court found a valid waiver extended the limitation period.

Practical Implications

This case reinforces the principle that family partnerships will be closely scrutinized to determine their economic reality for income tax purposes. Taxpayers cannot avoid tax liability by simply assigning income to family members through nominal partnerships. The key inquiry is whether the purported partners contribute capital or services and whether the taxpayer relinquishes control over the business. This case highlights the importance of documenting the economic substance of partnerships, especially those involving family members. Later cases applying this ruling have focused on demonstrating actual contributions of capital, labor, and control by all partners to establish the legitimacy of the partnership for tax purposes.