Dubinsky v. Commissioner, 22 T.C. 1123 (T.C. 1954)

Formal partnership agreements among family members are not sufficient to shift income for tax purposes if the partnership lacks economic substance and the income-generating control remains with the original owner.

Summary

In *Dubinsky v. Commissioner*, the Tax Court addressed whether income from a business, formally structured as a partnership with the owner's wife and children, should be taxed to the owner or the family members. The court held that despite operating agreements designating family members as partners, the arrangement lacked economic substance. The petitioner, Dubinsky, retained control of the business, and his family members did not contribute capital or substantial services. Therefore, the income was attributed to Dubinsky, the original owner and income earner, and not to the purported family partnership. The court also addressed and rejected the petitioner's statute of limitations defense for certain tax years.

Facts

Petitioner, Mr. Dubinsky, operated a business. He executed operating agreements with his wife, son, and daughter, designating them as partners in the business, formerly known as Dubinsky Bros. and later as Durwood-Dubinsky Bros. Profits were credited to these family members on the business books as partners. The Commissioner of Internal Revenue determined that these operating agreements did not create bona fide partnerships for tax purposes and included the profits credited to the family members in Mr. Dubinsky's taxable income.

Procedural History

The Commissioner assessed deficiencies against Mr. Dubinsky for the tax years 1938, 1939, 1940, and 1941, including in his income the profits attributed to his wife, son, and daughter under the partnership agreements. Mr. Dubinsky petitioned the Tax Court to contest the Commissioner's determination. The Tax Court reviewed the Commissioner's decision and considered arguments regarding the validity of the family partnerships and the statute of limitations for certain tax years.

Issue(s)

1. Whether the operating agreements between Mr. Dubinsky and his wife, son, and daughter created bona fide partnerships for federal income tax purposes, such that the income credited to the family members should be taxed to them and not to Mr. Dubinsky.
2. Whether the assessment and collection of deficiencies for the tax years 1938 and 1939 were barred by the statute of limitations.

Holding

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1. No, the operating agreements did not create bona fide partnerships for federal income tax purposes because the agreements lacked economic substance, and Mr. Dubinsky retained control and ownership of the income-generating business.
2. No, the assessment and collection of deficiencies for 1938 and 1939 were not barred by the statute of limitations because a valid waiver extended the limitation period for 1938, and for 1939, there was a substantial omission of income, extending the statutory period.

Court's Reasoning

The Tax Court, relying on *Commissioner v. Tower*, emphasized that state law recognition of partnerships is not controlling for federal tax purposes. The crucial issue is whether the parties genuinely intended to conduct business as partners. The court found that the operating agreements did not materially change the business operations or Mr. Dubinsky's control. The wife, son, and daughter did not invest capital originating from themselves nor contribute substantial services or management expertise. The court concluded that Mr. Dubinsky merely attempted a "paper reallocation of income among the family members." The court stated, "The giving of the leases and subleases by petitioner to the members of his family and the execution of the operating agreements made no material changes in the operation of the business. The control of petitioner over the business and property was as complete after the execution of the agreements as it had been before."

Regarding the statute of limitations, the court found that Mr. Dubinsky had executed a consent extending the assessment period for 1938. For 1939, the court noted that more than 25% of gross income was omitted from the return, triggering a five-year statute of limitations under Section 275(c) of the Revenue Act of 1938, which had not expired when the deficiency notice was issued.

Practical Implications

Dubinsky v. Commissioner, along with *Commissioner v. Tower*, provides critical guidance on the validity of family partnerships for tax purposes. It underscores that merely formalizing a partnership with family members is insufficient to shift income. Courts will scrutinize the economic reality of such arrangements, focusing on factors such as: (1) whether family members contribute original capital; (2) whether they provide substantial services to the partnership; (3) whether they participate in management and control; and (4) whether the partnership fundamentally alters the economic relationships within the family. This case serves as a reminder that income from personal services or capital remains taxable to the earner or owner unless a genuine and substantive business partnership exists. It informs tax planning by highlighting the need for family business arrangements to demonstrate real economic substance beyond mere income reallocation to achieve tax benefits.

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