7 T.C. 142 (1946)

A partnership formed without a legitimate business purpose, primarily to shift income tax liability within a family, can be disregarded by the IRS, with the income attributed to the individual who actually earned it.

Summary

Paul Greene, a partner in a construction firm, arranged for his wife and his business partner to form a separate equipment leasing company. The leasing company purchased equipment and immediately leased it back to Greene's construction firm. Greene's wife contributed capital borrowed from Greene and did not actively participate in the leasing business. The Tax Court held that Greene was taxable on the income of the leasing company attributable to his wife because the partnership lacked a legitimate business purpose and was created primarily to reduce Greene's tax liability. The court also addressed the tax implications of rental income from property held as tenants by the entireties.

Facts

Paul Greene was a partner in Johnson & Greene, a construction company. He conceived the idea of having his wife, Margaret, and his partner, Johnson, form a new partnership, Alliance Equipment Company, to purchase and lease equipment to Johnson & Greene. Margaret contributed $7,500 to Alliance, which she borrowed from Paul. Alliance then purchased road construction equipment and immediately leased it to Johnson & Greene. Alliance received most of its income from Johnson & Greene. Margaret had limited involvement in Alliance's business, signing only two checks, and she contributed no capital of her own, as she borrowed the money from her husband. Greene arranged the lease terms. The equipment was essential to Johnson & Greene's business. Paul and Margaret Greene also received rental income from property they held as tenants by the entireties.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Paul Greene's income tax liability for 1941. Greene contested the deficiency in the Tax Court, arguing that his wife was taxable on the income from Alliance Equipment Company and that he was not taxable on the entirety of rental income from the property held as tenants by the entireties.

Issue(s)

1. Whether Paul Greene was taxable on the income of Alliance Equipment Company distributable to his wife, given that the partnership was formed between his wife and his business partner and leased equipment to his construction firm.
2. Whether Paul Greene was taxable on all of the rental income derived from property owned with his wife as tenants by the entireties.

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Holding

1. No, because the Alliance Equipment Company lacked a legitimate business purpose and was created primarily to shift income tax liability from Paul Greene to his wife.
2. No, because in Michigan, income from property held as tenants by the entireties is taxable equally to each spouse.

Court's Reasoning

The Tax Court reasoned that Alliance Equipment Company served no legitimate business purpose other than to reduce Paul Greene's income tax liability. Margaret Greene contributed no capital originating with her and did not actively participate in the management or control of Alliance. The court emphasized that tax consequences flow from the substance of a transaction rather than its form, citing *Commissioner v. Court Holding Co., 324 U.S. 331*, and *Helvering v. Clifford, 309 U.S. 331*. The court found that Greene exercised control over the income-producing equipment through the creation of a subservient agency, Alliance. Regarding the rental income, the court recognized that under Michigan law, a tenancy by the entirety exists when property is conveyed to a husband and wife, and each spouse is taxable on one-half of the income from such property, citing *Harrison v. Schaffner, 312 U.S. 579*.

Practical Implications

Greene v. Commissioner illustrates the principle that the IRS and courts can disregard business structures, including partnerships, when they are formed primarily to avoid taxes and lack a legitimate business purpose. It reinforces the importance of ensuring that all partners in a partnership contribute capital, services, or control to the business. The case also clarifies that income from property held as tenants by the entireties is generally taxable equally to each spouse, regardless of which spouse manages the property or receives the income. This case is frequently cited in cases involving family partnerships and assignment of income doctrines. Tax advisors must carefully scrutinize the economic substance of transactions to ensure they align with their legal form to withstand IRS scrutiny.

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