Buffalo Meter Co. v. Commissioner of Internal Revenue, 10 T.C. 83 (1948)

A partnership formed by stockholders of a corporation to conduct a portion of the corporation's business should be recognized for tax purposes if it is a real economic entity, operates at arm's length with the corporation, and there is no evidence of income shifting or tax evasion.

Summary

Buffalo Meter Co. challenged the Commissioner's determination that a partnership formed by its stockholders should be disregarded for tax purposes, with the partnership's income taxed to the corporation. The Tax Court held that the partnership was a legitimate business entity. The stockholders of Buffalo Meter Co. formed a partnership to take over the manufacturing and selling division of the corporation, while the corporation retained the foundry. The court found the partnership was real, served sound business reasons, and operated independently at arm's length from the corporation with market-based transactions. Therefore, the partnership was recognized for tax purposes, and its income was not attributed to the corporation.

Facts

The stockholders of Buffalo Meter Co., a corporation, formed a partnership. The partnership acquired the manufacturing and selling division of the corporation's business. The corporation continued to operate its foundry business. The corporation sold its products to the partnership at market prices and purchased goods from the partnership at market prices. The corporation rented floor space and machinery to the partnership at fair rental value. The partnership was formed for sound business reasons in the opinion of the partners. The partnership functioned as a separate economic entity.

Procedural History

The Commissioner of Internal Revenue determined that the partnership of Buffalo Meter Co. should not be recognized for tax purposes and that the income should be taxed to the petitioner corporation. Buffalo Meter Co. challenged this determination in the Tax Court.

Issue(s)

1. Whether the partnership formed by the stockholders of Buffalo Meter Co. should be recognized for federal income tax purposes.

2. Whether the income attributed to the partnership should be taxed to the petitioner corporation under Section 22(a) or Section 45 of the Internal Revenue Code.

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Holding

1. Yes, the partnership formed by the stockholders of Buffalo Meter Co. should be recognized for federal income tax purposes because it was a real and separate economic entity.

2. No, the income attributed to the partnership should not be taxed to the petitioner corporation because there was no shifting of income or expenses and dealings were at arm's length.

Court's Reasoning

The court distinguished this case from those involving "unrealities or shams or anticipatory assignments of income" designed for tax evasion. The court emphasized that the partnership was not "unreal or a sham" and represented a "complete shift of economic interests" to the partners. The court noted stockholders' freedom to choose their business structure, stating, "As has been said repeatedly, the tax laws do not undertake to deny taxpayers the right of free choice in the selection of the form in which they carry on business." The division of business functions (foundry in corporation, manufacturing and selling in partnership) was deemed natural and not interdependent. Crucially, all transactions between the corporation and partnership were at arm's length, at market prices. The court found "no shifting of income or expenses" and no circumstances justifying allocation of income under Section 45. The court relied on the precedent of *Seminole Flavor Co., 4 T. C. 1215*, finding no material factual distinction.

Practical Implications

This case clarifies that partnerships formed by corporate stockholders can be recognized for tax purposes if they are genuine business entities with economic substance and operate independently. It underscores the importance of arm's length transactions between related entities. Legal practitioners should advise clients that forming partnerships for legitimate business reasons, with clear economic separation and fair market dealings, is permissible and will generally be respected by tax authorities. This case is a reminder that taxpayers have the right to choose their business form to minimize taxes, provided the chosen form is not a sham and has real economic effect. Later cases distinguish *Buffalo Meter Co.* based on the degree of interdependence between the corporation and partnership and the fairness of intercompany pricing.

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