T.C. Memo. 1951-38

A taxpayer has the right to choose their business structure, but the IRS can disregard sham entities created solely to evade taxes.

Summary

N.M. and Gladys Sellers formed a partnership, Coca-Cola Bottling Co. of Sacramento, to take over the bottling business previously run by their corporation, Sacramento Corporation. The IRS argued the partnership was a sham to reallocate income within the family. The Tax Court held that the partnership was a legitimate entity. However, the Court also examined whether the Sellers' children were bona fide partners, finding they were not, and their share of partnership income was attributed to their parents. The Court addressed whether Sacramento Corporation qualified for an excess profits credit carry-back, determining it was a personal holding company and thus ineligible.

Facts

- Sacramento Corporation, owned primarily by N.M. and Gladys Sellers, bottled and distributed Coca-Cola.
- N.M. and Gladys Sellers formed a partnership, Coca-Cola Bottling Co. of Sacramento, to conduct the bottling business.
- The partnership maintained separate books, bank accounts, and paid its own expenses.
- Sacramento Corporation retained ownership of some real estate and provided syrup to the partnership under a sub-bottling agreement.
- The Sellers' children were nominally included as partners in the partnership agreement.

Procedural History

The Commissioner of Internal Revenue determined that the partnership's income should be included in Sacramento Corporation's income and that the Sellers' children were not bona fide partners. The Sellers and Sacramento Corporation petitioned the Tax Court for review of these determinations. The Tax Court consolidated the cases.

Issue(s)

1. Whether the partnership, Coca-Cola Bottling Co. of Sacramento, should be recognized as a separate entity from Sacramento Corporation for tax purposes, or whether its income should be attributed to the corporation.
2. Whether Sacramento Corporation was a personal holding company in 1946, thus ineligible for an excess profits credit carry-back.
3. Whether the Sellers' children should be recognized as bona fide partners in the partnership for the years 1944 and 1945.

Holding

1. No, because the partnership operated as a distinct economic entity, maintaining separate books and accounts, holding title to assets, and bearing its own liabilities.
2. Yes, because Sacramento Corporation received more than 80% of its gross income from royalties and more than 50% of its stock was owned by five or fewer individuals.
3. No, because the children did not contribute substantial capital or services to the partnership, and the parents retained control of the business.

Court's Reasoning

The Court reasoned that the partnership was a legitimate entity, as it operated separately from the corporation. The agreement followed the pattern set up by the Coca-Cola company. The court noted the partnership had its own employees and bore its own liabilities. Regarding the excess profits credit carry-back, the Court determined Sacramento Corporation was a personal holding company because the 20 cents per gallon it retained from syrup sales constituted royalties, comprising the majority of its income. The Court found the children were not bona fide partners because they did not actively participate in the business, contribute significant capital, or exert control. The Court emphasized the parents retained complete control, and the children's contributions were not essential to the business's success, citing *Commissioner v. Culbertson*, 337 U.S. 733, which stated that intent to genuinely conduct a business is essential to a partnership determination.

Practical Implications

This case illustrates the importance of ensuring that business entities, especially family-owned businesses, have genuine economic substance and are not merely tax avoidance schemes. It highlights factors courts consider when evaluating the legitimacy of partnerships, including capital contributions, services rendered, and control exerted by the partners. The case also serves as a reminder that the IRS can recharacterize income and disregard entities lacking a legitimate business purpose. Furthermore, this case clarifies the definition of royalties for personal holding company purposes, emphasizing that payments tied to the use of an exclusive license can be considered royalties. Later cases may cite this ruling for evaluating sham transactions and imputed income in closely held business.

