T.C. Memo. 1951-38

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A taxpayer has the right to choose their business organization, but the IRS can disregard sham entities created solely to evade taxes; a family partnership is valid for tax purposes only if the parties genuinely intend to presently conduct business together.

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Summary

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The Tax Court addressed whether a corporation's income should include a partnership's earnings, if children were bona fide partners in a family business, and if a corporation qualified for an excess profits credit carry-back. The corporation, Sacramento Corporation, sub-bottled Coca-Cola. The corporation formed a partnership with the owners to conduct the bottling business. The IRS argued the partnership was a sham to reallocate income. The Court held that the partnership was a legitimate entity separate from the corporation, but the children were not bona fide partners and the corporation was a personal holding company, therefore, it was not entitled to the excess profits credit carry-back.

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Facts

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Sacramento Corporation, owned primarily by N.M. and Gladys Sellers, had a Coca-Cola bottling franchise. To reduce taxes, they formed a partnership, Coca-Cola Bottling Company of Sacramento, to take over the bottling and distribution business. The partnership included their two children, Jack and Virginia, as partners. Sacramento Corporation continued to exist, holding real estate and providing syrup to the partnership. The IRS challenged the validity of the partnership and the inclusion of the children as partners.

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Procedural History

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The Commissioner of Internal Revenue determined that the partnership's income should be included in Sacramento Corporation's gross income and that the children's shares of partnership income should be included in their parents' income. N.M. and Gladys Sellers, and Sacramento Corporation, petitioned the Tax Court for redetermination. The Tax Court consolidated the cases.

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Issue(s)

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1. Whether the partnership should be recognized as a separate entity from Sacramento Corporation, or whether its income should be attributed to the corporation.

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2. Whether Sacramento Corporation was entitled to an unused excess profits credit carry-back from 1946 to 1944.

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3. Whether the Sellers' children, Jack and Virginia, should be recognized as bona fide partners in the partnership for the years 1944 and 1945.

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Holding

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1. No, because the partnership operated as a distinct and separate economic entity with its own books, bank accounts, and contracts.

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2. No, because Sacramento Corporation was a personal holding company during 1946 and therefore was exempt from the excess profits tax.

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3. No, because the children did not contribute capital or services to the partnership, and there was no intent for them to presently conduct the business.

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Court’s Reasoning

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Regarding the partnership’s validity, the court emphasized that taxpayers can choose their business structure to minimize taxes, but sham entities are disregarded. The partnership maintained separate books, accounts, and bore its own liabilities. “The evidence shows that it was the intent of the parties that a partnership should take over and conduct the bottling and distributing business which the corporation previously had conducted, and that the operation of the bottling business actually was conducted by the partnership.”

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Concerning the excess profits credit, the court found that Sacramento Corporation received most of its income from royalties (the 20 cents per gallon retained from the syrup sales), making it a personal holding company exempt from the excess profits tax. “The 20 cents per gallon retained by Sacramento Corporation was in exchange for the corporation’s exclusive right to receive Coca-Cola syrup from Pacific Coast and exclusively to bottle and vend the Coca-Cola product in the Sacramento area… the 20 cents per gallon received by Sacramento Corporation above the amount which it had to remit to Pacific Coast constituted payment for the exclusive license granted to the partnership.”

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Regarding the children as partners, the court applied the “present conduct of a business” test from *Commissioner v. Culbertson*, finding no genuine intent to operate the business with the children during 1944 and 1945. Jack was in the Navy, Virginia provided minimal services, and their capital contribution was not proven to be necessary or used in the business.

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