19 T.C. 1197 (1953)

A partnership will be disregarded for tax purposes if it is determined to be a sham, lacking economic substance or a legitimate business purpose, and created solely to avoid income tax.

Summary

The Friedlander Corporation sought a redetermination of deficiencies assessed by the Commissioner, arguing that a partnership formed by some of its stockholders was valid and that its income should not be attributed to the corporation. The Tax Court upheld the Commissioner's determination, finding that the partnership lacked a legitimate business purpose and was created solely to siphon off corporate profits for tax avoidance. The court also disallowed deductions claimed for Rotary Club dues and partially disallowed salary expenses paid to stockholder sons serving in the military.

Facts

The Friedlander Corporation operated a general merchandise business through multiple stores. Louis Friedlander, the president and majority stockholder, transferred stock to his six sons. Later, to reduce tax liability, Louis formed a partnership, "Louis Friedlander & Sons," purchasing several retail stores from the corporation. The partners included Louis, his wife, another major stockholder I.B. Perlman and their wives, and three of Louis's sons. At the time of the partnership's formation, the sons were in military service and largely uninvolved in the business. The partnership's business was conducted in the same manner and under the same management as before its creation.

Procedural History

The Commissioner of Internal Revenue determined a deficiency against The Friedlander Corporation, asserting that the income reported by the partnership should be taxed to the corporation. The Friedlander Corporation petitioned the Tax Court for a redetermination of the deficiency.

Issue(s)

Whether the Tax Court erred in upholding the Commissioner's determination that the income of the partnership, Louis Friedlander & Sons, should be included in the taxable income of The Friedlander Corporation.

Holding

No, because the partnership was not entered into in good faith for a business purpose and was a sham created solely to avoid income tax.

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Court’s Reasoning

The court reasoned that while a taxpayer may choose any form of organization to conduct business, the chosen form will be disregarded if it is a sham designed to evade taxation. The court found several factors indicating that the partnership lacked a legitimate business purpose:

– The sons, purportedly intended to manage the partnership upon their return from military service, were unavailable to participate in the partnership’s affairs at its inception.
– I.B. Perlman, whose conflicting views with the sons were cited as a reason for forming the partnership, continued to manage the stores with the same authority as before.
– The partnership’s term was only five years, suggesting a temporary arrangement for tax benefits rather than a permanent business organization.
– Assets were transferred to the partnership at less than actual cost, indicating a release of earnings without adequate consideration.

Furthermore, the court emphasized that the predominant motive for creating the partnership was tax avoidance, as stated by Louis Friedlander himself. Quoting from precedent, the court stated, “Escaping taxation is not a ‘business’ activity.”

Practical Implications

This case reinforces the principle that the IRS and the courts will scrutinize partnerships, particularly family partnerships, to determine if they have economic substance beyond mere tax avoidance. It serves as a cautionary tale against structuring business arrangements primarily for tax benefits without a genuine business purpose. Subsequent cases cite this ruling to emphasize the importance of demonstrating a legitimate business reason for forming a partnership, especially when assets are transferred between related entities. Tax advisors must counsel clients to ensure that partnerships are structured with sound business objectives and that transactions between related entities are conducted at arm’s length to withstand scrutiny.

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