Friedlander Corp. v. Commissioner, 25 T.C. 170 (1955)

A family partnership will be disregarded for tax purposes if it lacks a legitimate business purpose and is created primarily to shift income from a corporation to its stockholders for tax benefits.

Summary

Friedlander Corporation sought to deduct club dues paid by its president and salaries paid to employees in military service. More significantly, the corporation argued that a family partnership it formed should be recognized as a separate entity for tax purposes. The Tax Court disallowed the club dues deduction, limited the salary deductions, and held that the partnership was a sham designed to avoid taxes, thus attributing the partnership's income back to the corporation. The court reasoned that the partnership lacked a genuine business purpose and was merely a scheme to reallocate corporate income to family members.

Facts

Friedlander Corporation operated a chain of retail stores. Louis Friedlander, the president, paid Notary Club dues personally for 21 years before seeking reimbursement from the corporation. The corporation also paid salaries to Irwin and Max Friedlander, Louis's sons, who were employees and stockholders, even while they were serving in the military. In 1943, the corporation formed a family partnership, purportedly to allow Louis's sons and another employee, Perlman, to manage stores independently upon their return from military service. The partnership operated six of the corporation's nine stores. The merchandise was transferred to the partnership at invoice cost, excluding transportation and handling charges. The sons were in military service when the partnership was formed, and Perlman managed the stores in their absence. The partnership generated substantial income during its existence.

Procedural History

The Commissioner of Internal Revenue disallowed deductions for club dues and portions of the salaries paid to Irwin and Max Friedlander. The Commissioner also determined that the income of the family partnership was taxable to Friedlander Corporation. The Friedlander Corporation petitioned the Tax Court for a redetermination of the deficiencies.

Issue(s)

1. Whether the Notary Club dues paid by the corporation's president are deductible as a business expense.
2. Whether the salaries paid to employees while they were in military service are deductible as a business expense to the extent paid.
3. Whether the family partnership should be recognized for tax purposes as a

separate enterprise from the Friedlander Corporation.

Holding

1. No, because the evidence failed to establish that the club membership was an ordinary and necessary business expense of the corporation.
2. No, because the corporation failed to demonstrate that the salaries paid during military service were necessary to retain experienced personnel or that replacements were not required.
3. No, because the partnership lacked a legitimate business purpose and was created primarily to siphon off income from the corporation for the benefit of its controlling stockholders.

Court's Reasoning

The court found insufficient evidence to support the deduction of club dues as a business expense. Regarding the salaries, the court noted that the employees were stockholders and sons of the corporation's head, making the motive for payments important. Since replacements were not required during their military service and no evidence suggested the payments were necessary to ensure their return, the deductions were limited. The court determined the family partnership was a sham, emphasizing that the sons were in military service when it was formed and Perlman continued to manage the stores as before. The court highlighted that the merchandise transfer was not an arm's length transaction, being made at invoice cost without including additional charges. The court stated, "Louis, the architect of the plan, testified, in effect, that taxation was the predominant motive for the creation of the partnership. Such a purpose, if the plan for its accomplishment is not unreal or a sham, is of course not fatal, but the separation here was only nominal and availed of for the obvious intent of temporarily reallocating, without consideration or business reasons, petitioner's income among family groups of petitioner's selection." Citing *Lucas v. Earl*, the court concluded that such anticipatory arrangements are ignored for tax purposes.

Practical Implications

This case underscores the importance of establishing a legitimate business purpose when forming family partnerships, particularly when connected to a corporation. Courts will scrutinize such arrangements, especially when transfers are not at arm's length and the primary motive appears to be tax avoidance. The ruling serves as a warning against using partnerships as mere conduits for shifting income without a genuine change in business operations. Later cases have cited *Friedlander* to emphasize the need for economic substance in business arrangements and to prevent taxpayers from using artificial structures to avoid taxes. Attorneys advising businesses on tax planning must ensure that any restructuring has a valid business purpose beyond tax reduction to withstand scrutiny from the IRS.