27 T.C. 989 (1957)

A family partnership will be recognized for tax purposes if it is established in good faith and for a legitimate business purpose, even if the limited partners do not contribute significant services or capital of their own, provided it aligns with the standards set forth in *Commissioner v. Culbertson*, 337 U.S. 733 (1949).

Summary

The United States Tax Court considered whether the wives of the general partners in a sportswear company should be recognized as valid limited partners, thus allowing income credited to them to be excluded from the general partners' taxable income. The court found that the partnership, which had previously been denied recognition in earlier proceedings, was established in good faith and for a valid business purpose: to retain a key employee. Because the formation of the limited partnership was critical to achieving this business goal, the court recognized the wives as partners, despite their lack of direct contribution to the business beyond their initial capital accounts.

Facts

Leon and Irving Fainblatt, along with their sister, Margaret, formed Lee Sportswear Co. They wanted to make a key employee, Harry Horowitz, a partner to retain his services. To achieve this, they agreed to make Horowitz a partner. However, Margaret felt that the brothers would have an unfair advantage over her if Horowitz was made a partner but she didn't receive any benefit. To resolve this issue, they made their wives limited partners to equalize their interests, as Horowitz demanded. The wives did not contribute cash to the partnership, but they were credited with capital accounts equal to half of their husbands' interests. They had no voice in the management, but participated in discussions about the business. The Tax Court had previously refused to recognize the wives as partners. The Commissioner determined deficiencies against the Fainblatts for the shares of income credited to their wives.

Procedural History

The case was initially brought before the United States Tax Court to challenge deficiencies determined by the Commissioner of Internal Revenue regarding the Fainblatts' tax liability for income attributed to their wives. The Tax Court had previously addressed the issue of the validity of this partnership for tax purposes. The Tax Court found against the Fainblatts in the first case. The Tax Court now reconsiders the case in light of *Commissioner v. Culbertson*. This opinion addressed the tax liabilities for the years in question.

Issue(s)

Whether the wives of the general partners should be recognized as valid limited partners in Lee Sportswear Co. for tax purposes?

Holding

Yes, because the formation of the limited partnership was prompted by a legitimate business purpose, and the arrangement was entered into in good faith.

Court's Reasoning

The court, referencing *Commissioner v. Culbertson*, focused on whether the partnership was formed in good faith for a business purpose. The court determined that the primary objective was to retain Horowitz, a key employee, who would only become a partner if the wives were included. Although the wives did not contribute capital or render services directly, their inclusion was essential to achieve the valid business purpose of keeping Horowitz. The court considered factors, as outlined in *Culbertson*, like the partnership agreement, the conduct of the parties, and their statements. The court noted that the wives participated in partnership discussions and considered this along with the business purpose to decide in favor of the Fainblatts.

Practical Implications

This case illustrates that a partnership, even one involving family members, can be recognized for tax purposes if it serves a genuine business purpose, which is determined using all facts and circumstances. The absence of capital or service contributions by a partner isn't necessarily fatal, provided the arrangement aligns with the standards set forth in *Culbertson* and that a legitimate business aim is clearly demonstrated. Attorneys should advise clients on the importance of documenting the business rationale behind partnership structures and ensuring all actions of the partners are consistent with the stated purpose. This case highlights the need to carefully consider the substance of transactions over form.

