34 T.C. 20 (1960)

In determining the deductibility of interest payments, the court will look beyond the form of a transaction to its substance, and disallow deductions where the primary purpose is tax avoidance through a sham transaction lacking economic reality.

Summary

In 1952 and 1953, the petitioners, Gordon and Sheila MacRae, sought to deduct substantial sums as interest expenses related to purchases of U.S. Treasury notes and Federal Land Bank bonds. The transactions were structured to create the appearance of borrowing money and paying interest, but the court found they lacked economic substance. The MacRaes, with the assistance of brokers, engaged in a series of highly leveraged transactions designed solely to generate tax deductions. The court held that because the transactions were devoid of economic reality and designed primarily for tax avoidance, the purported interest payments were not deductible.

Facts

Gordon MacRae, an entertainer, sought to reduce his tax liability through securities transactions. He was advised by his attorneys and a broker that he could purchase securities with borrowed funds and deduct the interest payments, and potentially realize capital gains. He ordered the purchase of U.S. Treasury notes and later Federal Land Bank bonds with minimal down payments, and the remainder financed through loans. The broker, Cantor, Fitzgerald & Co. (C-F), arranged simultaneous purchases and sales of the securities, with the actual transfer of funds and securities handled by clearing agents. C-F and another entity, Gibraltar, provided the loans. The transactions created the appearance of borrowing money and paying interest, but in reality, no funds were at risk other than the nominal costs of the transactions. MacRae issued checks to C-F and Gibraltar purportedly as interest payments, which he then sought to deduct on his tax returns.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the MacRaes' income tax for 1952 and 1953, disallowing the deductions for purported interest payments. The MacRaes contested the deficiencies, arguing that the payments qualified as deductible interest expenses. The case was heard before the U.S. Tax Court.

Issue(s)

1. Whether the payments made by the MacRaes to C-F and Gibraltar, and deducted as interest on their tax returns, represented bona fide interest on an existing indebtedness, or were merely part of a sham transaction designed to generate tax deductions.

Holding

1. No, because the court found that the transactions were not entered into in good faith for an economic purpose, but rather were designed solely for tax avoidance. The payments were, therefore, not deductible as interest.

Court's Reasoning

The court applied the principle of

