Derr v. Commissioner, 77 T. C. 708 (1981)

A transaction structured solely for tax avoidance, lacking economic substance, cannot support tax deductions.

Summary

In Derr v. Commissioner, the Tax Court ruled that a series of transactions involving the purchase and resale of an apartment complex by entities controlled by Edward J. Reilly were a sham, designed solely to generate tax deductions for limited partners in the Aragon Apartments partnership. The court found that the partnership did not acquire ownership of the property in 1973, and thus, was not entitled to claim deductions for depreciation, interest, or other expenses. This decision underscores the principle that tax deductions must be based on transactions with genuine economic substance.

Facts

In early 1973, Edward J. Reilly decided to syndicate the Aragon Apartments limited partnership to purchase and operate an apartment complex in Des Plaines, Illinois. He published a prospectus promising substantial tax benefits for 1973, indicating his corporation, Happiest Partner Corp. (HPC), had contracted to buy the property. However, no such contract existed at the time of publication. On June 30, 1973, HPC entered into a contract to purchase the property, and on July 1, 1973, HPC agreed to sell its interest to Aragon. The terms of the sale reflected the tax benefits promised in the prospectus. Petitioner William O. Derr, a limited partner, claimed a deduction for his share of the partnership's alleged loss for 1973.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the petitioners' 1973 federal income tax and disallowed the claimed deduction. The petitioners challenged this determination in the U. S. Tax Court, which heard the case and rendered its decision on September 29, 1981.

Issue(s)

1. Whether the transactions involving the purchase and resale of the apartment complex by HPC were a sham, lacking economic substance.
2. Whether Aragon Apartments acquired ownership of the apartment complex in 1973, entitling it to claim deductions for depreciation, interest, and other expenses.
3. Whether the petitioners are entitled to a deduction for Mr. Derr's distributive share of the partnership loss for 1973.

Holding

1. Yes, because the transactions were orchestrated by Reilly solely to create the

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appearance of a completed sale in 1973 and fabricate tax deductions, lacking any legitimate business purpose.
2. No, because Aragon did not acquire the benefits and burdens of ownership until July 1, 1974, and thus was not entitled to claim any deductions for 1973.
3. No, because Aragon did not sustain a deductible loss during 1973, as it had no depreciable interest in the property or any other deductible expenses.

Court's Reasoning

The court applied the substance-over-form doctrine, determining that the transactions were a sham because they lacked economic substance and were designed solely for tax avoidance. The court found that HPC acted as Aragon's agent or nominee in the purchase agreement, and Aragon was the real purchaser. The court also noted the absence of arm's-length dealing, as Reilly controlled both entities. The court rejected the labels attached to payments made by Aragon, such as 'prepaid interest' and 'management fees,' as they did not reflect economic reality. The court relied on cases like *Gregory v. Helvering* and *Knetsch v. United States* to support its conclusion that transactions without a business purpose and lacking economic substance cannot support tax deductions.

Practical Implications

This decision reinforces the importance of economic substance in tax transactions. Attorneys and tax professionals must ensure that transactions have a legitimate business purpose beyond tax avoidance to support claimed deductions. The ruling impacts how tax shelters are structured and marketed, emphasizing the need for genuine economic activity. Businesses engaging in similar transactions must be cautious of IRS scrutiny and potential disallowance of deductions. Subsequent cases, such as *Red Carpet Car Wash, Inc. v. Commissioner*, have cited *Derr* in upholding the principle that sham transactions cannot support tax benefits.

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