T.C. Memo. 1984-59

Income is taxed to the individual who earns it, and sham transactions designed to avoid taxation will be disregarded for federal income tax purposes.

Summary

Max Benningfield attempted to avoid income tax by assigning his wages to a purported trust, “Professional & Technical Services” (PTS), and claiming a deduction for a “factor discount on receivables sold.” He also claimed a deduction for “financial counseling” fees paid to “International Dynamics, Inc.” (IDI). The Tax Court disallowed both deductions and upheld a negligence penalty. The court found that Benningfield remained in control of earning his income and that the transactions lacked economic substance, constituting a sham designed solely to avoid taxes. The court emphasized the fundamental principle that income is taxed to the one who earns it and that deductions require actual expenditure for a legitimate purpose.

Facts

Max Benningfield, a steamfitter, entered into contracts with PTS and IDI, entities associated with Trust Trends. Under an “Intrusted Personal Services Contract,” Benningfield purported to sell his future services to PTS for $1 per year and various “economic justifications.” He endorsed his paychecks from J.A. Jones Construction Co. to PTS and claimed a deduction for a “factor discount.” Simultaneously, he received back approximately 90% of the paycheck amount from IDI Credit Union as purported “gifts.” Benningfield also entered into a “Financial Management Consulting Services” contract with IDI, paying a fee of $3,550 and receiving back $3,195 as a “gift” from IDI Credit Union. He deducted the full $3,550 as “financial counseling” expenses. J.A. Jones Construction Co. was unaware of Benningfield’s arrangements with PTS and IDI.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Benningfield’s federal income taxes for the years 1975-1979 and assessed negligence penalties. Benningfield petitioned the Tax Court to contest these determinations.

Issue(s)

1. Whether the deduction claimed as a “factor discount on receivables sold,” representing wages assigned to PTS, is allowable.
2. Whether the deduction of $3,550 for “financial counseling” is allowable.
3. Whether Benningfield is liable for the negligence addition to tax under section 6653(a) of the Internal Revenue Code.

Holding

1. No, because the assignment of income to PTS was ineffective for federal income tax purposes, and Benningfield remained taxable on the wages he earned.
2. No, because Benningfield did not actually expend $3,550 for financial counseling due to the near simultaneous return of $3,195, and the expense lacked substantiation and a valid deductible purpose.
3. Yes, because Benningfield was negligent in participating in a flagrant tax-avoidance scheme, demonstrating an intentional disregard of tax rules and regulations.

Court's Reasoning

The Tax Court reasoned that the "factor discount" deduction was based on an ineffective assignment of income. Citing *Lucas v. Earl*, 281 U.S. 111 (1930), the court reiterated the fundamental principle that "income must be taxed to the one who earns it." The court found that PTS did not control Benningfield's earning of income; he continued to work for J.A. Jones Construction Co., who was unaware of the PTS arrangement. The court deemed the services contract a sham, stating, "We will not sanction this flagrant and abusive tax-avoidance scheme."

Regarding the financial counseling deduction, the court noted that deductions are a matter of legislative grace and require actual expenditure for a deductible purpose. Citing *Deputy v. du Pont*, 308 U.S. 488 (1940), the court found that Benningfield effectively only expended $355 ($3,550 – $3,195). Furthermore, he failed to prove that even this amount was for a deductible purpose under sections 162 or 212 of the Internal Revenue Code. The court concluded the financial management contract also lacked economic substance.

Finally, the court upheld the negligence penalty under section 6653(a), finding that Benningfield's participation in the tax-avoidance scheme was negligent. Quoting *Hanson v. Commissioner*, 696 F.2d 1232, 1234 (9th Cir. 1983), the court stated, "No reasonable person would have trusted this scheme to work." The court emphasized Benningfield's failure to seek professional advice and the blatant nature of the tax avoidance attempt.

Practical Implications

Benningfield serves as a clear illustration of the assignment of income doctrine and the sham transaction doctrine in tax law. It reinforces that taxpayers cannot avoid tax liability by merely redirecting their income through contractual arrangements, especially when they retain control over the income-generating activities. The case cautions against participation in tax schemes that appear "too good to be true" and emphasizes the importance of economic substance for deductions. It highlights that deductions require actual, substantiated expenses incurred for legitimate business or personal purposes as defined by the tax code. The case also demonstrates the willingness of courts to impose negligence penalties in cases involving abusive tax avoidance schemes, particularly those lacking any semblance of economic reality.

