Raum v. Commissioner, 83 T. C. 30 (1984)

A tax shelter disguised as a business, lacking economic substance, does not qualify for tax deductions.

Summary

Raum, an attorney, claimed tax deductions for losses from a gemstone distributorship tax shelter. The Tax Court ruled that the scheme, structured as an exclusive territorial franchise, was a sham with no economic substance. The court found that the franchise lacked a binding contract, had no genuine business purpose, and was designed solely for tax avoidance. Consequently, Raum was denied deductions for the purported distributorship fees and related expenses, although he was allowed deductions for actual out-of-pocket expenses related to unrelated jewelry sales.

Facts

Raum, a California attorney experienced in tax law, invested in a gemstone distributorship tax shelter organized by attorneys Laird and Crooks. The shelter involved purchasing an exclusive territorial distributorship from U. S. Distributor, Inc. , which had rights to distribute products from American Gold & Diamond Corp. Raum paid $384,000 for his distributorship, intending to claim deductions for the payments. He made no sales in his assigned territory and relied on Gem-Mart, a subsidiary of American Gold, to conduct sales elsewhere. The distributorship agreement was poorly drafted, lacked specificity about the territory, and was not seriously regarded by the parties involved.

Procedural History

The IRS determined deficiencies in Raum's 1979 and 1980 tax returns, disallowing losses claimed from the gemstone distributorship. Raum petitioned the Tax Court for a redetermination. The Tax Court held that the distributorship was a sham and denied the deductions related to the distributorship fees but allowed deductions for actual expenses incurred in unrelated jewelry sales.

Issue(s)

1. Whether the gemstone distributorship scheme was a sham lacking economic substance, thus not qualifying for tax deductions under IRC Sections 162 and 1253?

2. Whether Raum's jewelry transactions conducted outside his exclusive territory could be considered part of the distributorship for tax purposes?

Holding

1. Yes, because the court found the distributorship to be a sham with no genuine

business purpose, designed solely for tax avoidance, and thus not eligible for deductions under IRC Sections 162 and 1253.

2. No, because the jewelry transactions were unrelated to the exclusive territorial franchise and could not be blended with the sham distributorship to support deductions.

Court’s Reasoning

The court applied the economic substance doctrine, finding that the distributorship scheme lacked substance beyond tax avoidance. The court noted the absence of a binding contract, the illusory nature of the rights granted, and the lack of genuine business activity in the assigned territory. The court emphasized that the scheme was akin to other tax shelters involving inflated asset sales. It rejected Raum’s attempt to blend unrelated jewelry sales with the sham distributorship, stating these were separate activities. The court also found that the agreement’s drafting errors and the parties’ conduct further supported its sham finding. The court dismissed Raum’s attempt to shift the burden of proof, stating he failed to establish that his activities qualified under IRC Section 183.

Practical Implications

This decision underscores the importance of economic substance in tax shelter arrangements. Attorneys should advise clients that tax shelters lacking a genuine business purpose are at risk of being deemed shams. The ruling affects how tax professionals structure and defend tax shelters, emphasizing the need for real economic activity and careful drafting of agreements. Businesses considering tax shelters must ensure they have legitimate business operations to support claimed deductions. This case has been cited in subsequent tax shelter litigation to support the denial of deductions for schemes lacking economic substance.

