85 T.C. 332 (1985)

Transactions lacking economic substance and solely intended for tax benefits are considered shams and will be disregarded by the IRS, and expenses paid by a corporation for the personal benefit of shareholders can be treated as constructive dividends.

Summary

The Tax Court disallowed deductions claimed by limited partners in a real estate partnership, Monterey Pines Investors (MPI), finding the purported purchase of an apartment complex to be a sham transaction lacking economic substance. The court determined that a series of back-to-back sales artificially inflated the property's value and that MPI never genuinely acquired an interest in the property. Additionally, personal expenses of the Falsettis, shareholders of Mikomar, Inc., paid by the corporation were deemed constructive dividends. The court focused on the lack of arm's-length dealing, inflated pricing, and disregard for contractual terms to conclude the real estate transaction was a tax shelter scheme. For the constructive dividend issue, the court examined whether corporate expenses provided economic benefit to the shareholders without serving a legitimate corporate purpose.

Facts

Individual petitioners invested in Monterey Pines Investors (MPI), a limited partnership purportedly formed to purchase and operate an apartment complex. MPI purportedly purchased the property from World Realty Systems, Inc. (World Realty), a Cayman Islands corporation, which in turn purportedly purchased it just days earlier from Jackson-Harris, a partnership partly owned by Thomas Harris, the promoter of MPI. The purchase price increased significantly with each sale, from \$1.88 million to \$2.85 million in a short period. MPI made interest payments, but these funds were ultimately used to service Jackson-Harris's debt on the original purchase. Petitioners were later cashed out for their initial investment plus 10% interest. Separately, the Falsettis owned Mikomar, Inc., which deducted auto, boat, travel, and insurance expenses. The IRS determined these were personal expenses of the Falsettis.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income taxes, disallowing deductions related to Monterey Pines Investors and treating certain corporate expenses as constructive dividends to the Falsettis. The cases were consolidated in the United States Tax Court. The case of Monterey Pines Investors (docket No. 20833-83) is regarding liability for withholding tax and penalties. The other dockets (7013-82, 5437-83, 5438-83, 7111-83) concern the individual partners' deductions and the Falsettis' constructive dividends.

Issue(s)

1. Whether Monterey Pines Investors was engaged in a bona fide business activity during 1976 and 1977, entitling its partners to deductions.
2. Whether purported interest payments made by Monterey Pines Investors were actually interest and deductible.
3. Whether expenses paid by Mikomar, Inc. for auto, boat, travel, and insurance related to the Falsettis were constructive dividends.
4. Whether Monterey Pines Investors was liable for withholding tax under section 1442 and penalties under section 6651(a) for purported interest payments to a foreign corporation.

Holding

1. No, because the purported sale of the apartment complex to Monterey Pines Investors was a sham transaction lacking economic substance.
2. No, because the transaction was a sham, and the payments were not genuine interest but merely a shifting of funds controlled by Harris.
3. Yes, in part. Certain auto expenses (25%) were deemed business-related, but boat, travel, and most auto expenses were constructive dividends.
4. No, because Monterey Pines Investors' involvement was a sham, and the payments were not actually made to a foreign corporation in a bona fide transaction.

Court's Reasoning

The court applied the "sham in substance" doctrine, defining it as "the expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits." The court found the sale from World Realty to MPI was not an arm's-length transaction, noting Harris's control over both sides and the inflated purchase price. The court emphasized factors from *Grodt & McKay Realty, Inc. v. Commissioner* to assess whether a sale occurred, including passage of title, treatment by parties, equity acquisition, obligations, possession, taxes, risk of loss, and profits. The court highlighted:

- Lack of arm's-length dealing: Harris controlled transactions, and Biggs, representing MPI, was related to Harris.
- Inflated purchase price: The price increased by nearly $1 million in 10 days without justification, exceeding fair market value.
- Inconsistent treatment: MPI did not act as the property owner; Jackson-Harris continued to use the property as collateral for loans.
- Disregard of contract terms: Payments did not follow the purported contract, and funds went to service Jackson-Harris's debts.

Regarding constructive dividends, the court applied the Ninth Circuit's two-part test: (1) the expense must be nondeductible to the corporation and (2) it must provide economic benefit to the shareholder. For the Blazer auto expenses, applying *Cohan v. Commissioner*, the court approximated 75% business use and 25% personal use, allowing partial deduction. Boat and travel expenses failed substantiation requirements under section 274(d) and were deemed personal benefits. Health and life insurance premiums for Falsetti were also considered personal benefits and constructive dividends.

Practical Implications

Falsetti v. Commissioner serves as a strong warning against tax shelters structured as sham transactions. It reinforces the IRS's ability to disregard transactions lacking economic substance, even if they are formally documented as sales. The case highlights the importance of:

- Arm's-length transactions: Dealings between related parties are scrutinized, especially when tax benefits are a primary motive.
- Fair market value: Inflated pricing in transactions, particularly in back-to-back sales, raises red flags.
- Economic substance: Transactions must have a genuine business purpose and economic reality beyond tax avoidance.
- Substantiation: Taxpayers must maintain thorough records to support deductions, especially for travel and entertainment expenses.
- Constructive dividends: Shareholders of closely held corporations must be cautious about using corporate funds for personal expenses, as these can be taxed as dividends even if not formally declared.

This case is frequently cited in tax law for the sham transaction doctrine and its application to disallow deductions from abusive tax shelters. It provides a framework for analyzing similar cases involving questionable real estate transactions and the treatment of shareholder benefits in closely held corporations.