Waddell v. Commissioner, 86 T. C. 889 (1986)

A purported debt in a tax shelter investment is not recognized for tax purposes if it is too contingent and speculative to be paid.

Summary

In Waddell v. Commissioner, the Tax Court examined the validity of a $25,000 promissory note issued by taxpayers purchasing Comp-U-Med ECG terminals under a franchise agreement. The court determined that the note was not a true debt for tax purposes due to its highly contingent nature and the inadequate security of the terminals. The taxpayers were thus limited to their cash investment for depreciation and investment credit purposes. The decision highlights the importance of evaluating the likelihood of debt repayment and the security's value in tax shelter arrangements, affecting how similar investments should be structured and analyzed.

Facts

Warner and Virginia Waddell purchased four Comp-U-Med ECG terminal franchises, each including a terminal priced at $27,500. They paid $6,000 cash per franchise and issued a $25,000 promissory note, labeled as recourse but convertible to nonrecourse. The note required a minimum annual payment of $1,500, with principal payments contingent on net revenues from leasing the terminals. Comp-U-Med treated the note as a contingent liability on its books. The Waddells claimed deductions and credits based on the full purchase price, which the IRS challenged, asserting the note was not a true debt.

Procedural History

The IRS issued a notice of deficiency for the Waddells' 1980 tax return, disallowing claimed deductions and credits related to the Comp-U-Med investment. The Waddells petitioned the Tax Court, which designated the case as a test case for similar investments. The court heard arguments on whether the Waddells' activity was profit-motivated, whether the terminals were placed in service, and the validity of the purchase money note as a true debt for tax purposes.

Issue(s)

1. Whether the Waddells' acquisition and operation of the Comp-U-Med ECG terminal franchises was an activity engaged in for profit.
2. Whether the Waddells' computerized ECG terminals were placed in service during 1980.
3. Whether the Waddells' purchase money note in the principal amount of $25,000 was a true debt for Federal tax purposes.
4. Whether the Waddells were "at risk" under section 465 for the full amount of the note.
5. Whether the Waddells' failure to timely file their 1980 Federal income tax return

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was due to reasonable cause and not due to willful neglect.

Holding

1. Yes, because the Waddells had an actual and honest objective of deriving an economic profit, independent of tax savings.
2. Yes, because the terminals were available for use in the Waddells' leasing venture from the date of purchase.
3. No, because the note was too contingent and speculative to be treated as a true indebtedness, as the security was inadequate and payment unlikely.
4. No, because the Waddells were only at risk for their cash investment, as the note was not a true debt and Comp-U-Med had an interest in the activity beyond that of a creditor.
5. No, because the Waddells failed to show reasonable cause for their late filing.

Court's Reasoning

The court applied the profit motive test under section 183, finding the Waddells had a genuine intent to profit despite the investment's tax shelter features. The terminals were deemed placed in service in 1980 as they were available for leasing. The court analyzed the purchase money note under the "reasonable security" and "contingent obligation" theories, concluding it was not a true debt. The note's repayment was contingent on net revenues, which were unlikely given the terminals' low market value ($6,500) compared to the purchase price and the low usage rates in the industry. Comp-U-Med's treatment of the note as a contingent liability on its books supported this conclusion. The Waddells' at-risk amount was limited to their cash investment due to the note's invalidity and Comp-U-Med's interest in the venture's profits. The late filing penalty was upheld as the Waddells provided no reasonable cause for the delay.

Practical Implications

This decision impacts how tax shelter investments should be structured and analyzed. It emphasizes the need for adequate security and a reasonable likelihood of debt repayment for a purported debt to be recognized for tax purposes. Taxpayers and practitioners must carefully evaluate the economic substance of financing arrangements, particularly in tax shelter scenarios, to avoid disallowance of deductions and credits. The ruling may deter similar tax shelter schemes that rely on inflated purchase prices and contingent repayment obligations. Subsequent cases have cited Waddell to support the principle that purported debts must be bona fide to be included in basis for tax purposes.

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