Price v. Commissioner, 88 T. C. 860 (1987)

Fictitious or sham transactions cannot generate deductible losses or interest expenses for tax purposes.

Summary

In Price v. Commissioner, the Tax Court ruled that partnerships controlled by the petitioners engaged in fictitious transactions with dealers in government securities, resulting in disallowed tax deductions. The court found these prearranged transactions, involving billions of dollars in securities that did not exist, were shams designed solely to generate tax losses. While the court disallowed the deductions for losses and interest from these sham transactions, it allowed deductions for fees paid to arrange the transactions, as they were linked to the partnerships' business of selling to customers. The decision also upheld fraud penalties against one of the petitioners, Lawrence Price, due to his knowing involvement in these fictitious trades.

Facts

In 1978 and 1979, partnerships controlled by E. Lawrence and Lonnie Price (Newcomb Government Securities, Price & Co. , and Magna & Co.) engaged in prearranged transactions with dealers in government securities. These transactions were designed to generate tax losses for the partnerships while allowing them to sell offsetting positions to their customers. The transactions were arranged by James Ruffalo and involved no actual transfer of securities, with dealers receiving a guaranteed fee without market risk. The partnerships claimed significant tax deductions based on these transactions, which the IRS challenged as fictitious.

Procedural History

The IRS issued notices of deficiency to the Prices for 1978 and 1979, disallowing the claimed losses and interest deductions from the partnerships' transactions. The Prices petitioned the Tax Court, which consolidated the cases. The IRS later amended its position, asserting that the transactions were shams and that fraud penalties should apply to Lawrence Price.

Issue(s)

1. Whether the transactions between the partnerships and dealers were bona fide trades of government securities.
2. If not, whether the petitioners may deduct their distributive share of partnership trading losses, interest expenses, and fees from these transactions.
3. Whether any underpayment of tax was due to fraud.
4. Whether the petitioners are liable for an increased rate of interest under section 6621(c) of the Internal Revenue Code.

Holding

1. No, because the transactions were fictitious and lacked economic substance.
2. No, because the claimed deductions for losses and interest from sham transactions are not allowable, but fees paid to arrange customer transactions are deductible.
3. Yes, because Lawrence Price knowingly participated in the fictitious transactions to evade taxes, but not for Lonnie Price due to lack of knowledge.
4. Yes, because the underpayments resulted from sham transactions, making the petitioners liable for increased interest under section 6621(c).

Court's Reasoning

The court determined that the transactions were shams based on their prearranged nature, the lack of actual securities, and the small margin deposits relative to the transaction size. The court cited the absence of economic substance and the intent to manufacture tax losses as key factors. It emphasized that for tax deductions to be valid, the underlying transactions must be real and entered into for profit. The court allowed the deduction of fees paid to arrange the transactions, as these were linked to the partnerships' business of selling to customers. The fraud penalty was upheld against Lawrence Price due to his intimate involvement and knowledge of the scheme, but not against Lonnie Price, who lacked the same level of understanding. The court also applied the increased interest rate under section 6621(c) due to the sham nature of the transactions.

Practical Implications

This decision underscores the importance of economic substance in tax transactions, warning taxpayers and tax professionals against engaging in or promoting sham transactions. It impacts how similar cases should be analyzed, focusing on whether transactions have a legitimate business purpose beyond tax benefits. The ruling also affects legal practice by reinforcing the IRS's ability to challenge and disallow deductions from transactions lacking economic substance. For businesses, it highlights the risk of fraud penalties and increased interest rates when engaging in tax-motivated transactions. Subsequent cases like DeMartino v. Commissioner have applied this ruling, emphasizing the need for real economic activity to support tax deductions.

