Cherin v. Commissioner, 89 T. C. 986 (1987)

A transaction lacking economic substance will not be recognized for tax purposes, regardless of the taxpayer's profit motive.

Summary

Ralph Cherin invested in Southern Star's cattle tax shelter program, expecting to profit from cattle sales. The court found the transactions lacked economic substance and the benefits and burdens of ownership did not transfer to Cherin. The cattle's inflated prices and Southern Star's complete control over the cattle indicated the transactions were shams. The court disallowed Cherin's tax deductions and applied increased interest rates under IRC section 6621(c) due to the sham nature of the transactions. This case emphasizes the importance of economic substance in tax shelters and the irrelevance of a taxpayer's profit motive in determining the validity of such transactions.

Facts

Ralph Cherin invested in Southern Star's cattle program in 1971 and 1972, purchasing herds of Aberdeen Angus cows and interests in bulls. The cattle were managed by Southern Star under agreements that gave them complete control over the cattle's location, maintenance, breeding, and sales. Cherin relied on his financial advisor's recommendation and expected the herds to grow and generate income for his retirement. However, the cattle allocated to Cherin were of inferior quality, and Southern Star failed to meet its obligations. Cherin ceased payments in 1975 and never received any proceeds from the cattle's purported sale or liquidation.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Cherin's federal income tax for the years 1972-1978 and asserted that the deficiencies were due to tax-motivated transactions. Cherin petitioned the U. S. Tax Court, which found the Southern Star transactions similar to those in Hunter, Siegel, and Jacobs, where the court had previously held that the transactions lacked economic substance. The Tax Court ruled in favor of the Commissioner, disallowing Cherin's deductions and applying increased interest rates under IRC section 6621(c).

Issue(s)

1. Whether the transactions between Cherin and Southern Star lacked economic substance and thus should not be recognized for tax purposes.
2. Whether the benefits and burdens of ownership of the cattle were transferred to Cherin.
3. Whether the increased interest rate under IRC section 6621(c) should apply due to the sham nature of the transactions.

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Holding

1. Yes, because the transactions lacked economic substance as the cattle's stated prices were grossly inflated compared to their actual value, and Southern Star retained complete control over the cattle.
2. No, because Southern Star retained control over the cattle and Cherin had no right to possession or profits until the full purchase price was paid, which was economically improbable.
3. Yes, because the transactions were shams lacking economic substance, triggering the increased interest rate under IRC section 6621(c).

Court's Reasoning

The court applied the economic substance doctrine, holding that the Southern Star transactions were shams because they lacked economic substance. The cattle's inflated prices (4. 5 times their actual value) and Southern Star's complete control over the cattle indicated that the transactions were designed to generate tax benefits rather than genuine economic activity. The court rejected Cherin's argument that his profit motive should be considered, stating that a transaction's economic substance is determined objectively, not subjectively. The court also found that the benefits and burdens of ownership did not pass to Cherin, as Southern Star retained control and Cherin had no right to possession or profits. The court applied IRC section 6621(c), which imposes increased interest rates on substantial underpayments attributable to tax-motivated transactions, including shams. Judge Swift concurred but argued that the taxpayer's profit motive should be considered. Judges Chabot and Sterrett dissented, arguing that a transaction's economic substance should not be determinative if the taxpayer had a profit motive.

Practical Implications

This case underscores the importance of economic substance in tax shelters. Taxpayers and practitioners should carefully evaluate the economic viability of transactions beyond their tax benefits. The court's rejection of Cherin's profit motive argument means that even well-intentioned investors can be denied tax benefits if the underlying transactions lack economic substance. This ruling may deter investment in tax shelters that rely on inflated asset values or arrangements where the promoter retains significant control. Subsequent cases have cited Cherin in applying the economic substance doctrine and IRC section 6621(c). Practitioners should advise clients to seek genuine business opportunities rather than relying solely on tax benefits, as the IRS and courts will scrutinize transactions for economic substance.

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