Friendship Dairies, Inc. v. Commissioner, 90 T. C. 1054 (1988)

The investment tax credit cannot be considered as a substitute for or component of economic profit in determining the economic substance of a transaction for tax purposes.

Summary

Friendship Dairies, Inc. engaged in a prearranged transaction to purchase and lease back computer equipment through intermediaries, aiming to claim investment tax credits. The U. S. Tax Court ruled that the transaction lacked economic substance because it could not yield a profit without the tax credit, and thus, the tax benefits were disallowed. The court emphasized that the investment tax credit was not intended to transform unprofitable transactions into profitable ones, and upheld the application of increased interest rates for tax-motivated transactions under section 6621(c).

Facts

Friendship Dairies, Inc. purchased IBM computer equipment from O. P. M. Leasing Services, Inc. through an intermediary, Starfire Leasing Corp. , on September 26, 1980. The equipment was immediately leased back to O. P. M. , who then subleased it to R. L. Polk & Co. , Inc. for 48 months. Friendship Dairies expected to generate a profit solely through the investment tax credit, as the transaction’s cash flows did not promise any economic profit without it. The company’s president relied on assumptions about the equipment’s residual value, which were based on biased and outdated information.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Friendship Dairies’ income tax and disallowed the claimed investment tax credit. Friendship Dairies petitioned the U. S. Tax Court, which upheld the Commissioner’s determination on May 23, 1988, ruling that the transaction lacked economic substance and was thus not recognized for tax purposes.

Issue(s)

1. Whether Friendship Dairies’ purchase and leaseback of the computer equipment had economic substance to be respected for federal income tax purposes?
2. Whether the investment tax credit should be considered in determining the economic substance of the transaction?
3. Whether the increased rate of interest under section 6621(c) applies to the underpayment?

Holding

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1. No, because the transaction had no economic substance; it was motivated solely by tax benefits and could not yield a profit without the investment tax credit.
2. No, because the investment tax credit is not a substitute for economic profit and was not intended to transform unprofitable transactions into profitable ones.
3. Yes, because the transaction was tax-motivated and resulted in a substantial underpayment, triggering the increased interest rate under section 6621(c).

Court's Reasoning

The court applied the two-pronged test from *Frank Lyon Co. v. United States* to determine economic substance, focusing on whether the transaction was motivated by non-tax business purposes and whether it had a reasonable possibility of profit. Friendship Dairies failed both prongs. The court examined legislative history to conclude that the investment tax credit, part of the Revenue Act of 1962, was not intended to be a substitute for economic profit but rather an incentive for capital investment. The court rejected Friendship Dairies' argument that the tax credit should reduce the cost basis of the equipment for economic substance analysis, citing that such an approach would distort congressional intent. The court also upheld the application of the increased interest rate under section 6621(c) due to the tax-motivated nature of the transaction.

Practical Implications

This decision reinforces the importance of economic substance in tax planning, particularly in sale and leaseback transactions. Taxpayers cannot rely on tax credits to create economic substance where none exists. It highlights the need for transactions to have a genuine business purpose and potential for economic profit independent of tax benefits. The ruling may deter similar tax-motivated transactions and could lead to increased scrutiny of transactions involving investment tax credits. Subsequent cases, such as *ACM Partnership v. Commissioner*, have cited this decision in upholding the economic substance doctrine. Practitioners must ensure that clients understand the risks of engaging in transactions lacking economic substance, as such transactions may not be respected for tax purposes and could result in penalties and increased interest rates.

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