McCrary v. Commissioner, 92 T. C. 827 (1989)

A transaction devoid of economic substance is not recognized for tax purposes, even if the taxpayer subjectively intended to make a profit.

Summary

The McCrarys invested in a master recording lease program promoted by American Educational Leasing (AEL), claiming deductions and an investment tax credit based on the purported value of the leased recording. The Tax Court found the transaction lacked economic substance, disallowing the claimed tax benefits. The court held that the McCrarys' subjective profit intent was not credible and did not change the outcome under the unified economic substance test. The decision clarifies that tax benefits cannot be claimed for transactions lacking economic reality, even with a subjective profit motive.

Facts

Ronald McCrary, a bank loan officer, entered into an agreement with AEL in December 1982 to lease a master recording titled "The History of Texas" for $9,500 and paid an additional $1,500 to a distributor. The agreement promised significant tax benefits, including an investment tax credit of $18,500. The McCrarys claimed these deductions on their 1982 and 1983 tax returns. The master recording was produced at minimal cost and had negligible fair market value. AEL paid $1,000 and issued a non-negotiable note for $185,000 to acquire the recording. McCrary made no serious efforts to market the recording and received no sales reports.

Procedural History

The Commissioner of Internal Revenue issued a deficiency notice disallowing the claimed deductions and credits. The McCrarys filed a petition with the U. S. Tax Court. Before trial, they conceded the investment tax credit but continued to claim the deductions. The Tax Court found for the Commissioner, disallowing all claimed deductions and upholding additions to tax.

Issue(s)

1. Whether the McCrarys are entitled to deductions arising from their master recording transaction with AEL?

2. Whether the McCrarys are liable for additions to tax under sections 6653(a), 6659, and 6661 of the Internal Revenue Code?

Holding

1. No, because the transaction lacked economic substance and the McCrarys did not have an actual and honest profit objective.

© 2025 SCOTUSreports.com. All rights reserved.

2. Yes, because the McCrarys were negligent and intentionally disregarded tax rules, and the underpayment was substantial, but not attributable to a valuation overstatement.

Court's Reasoning

The court applied the unified economic substance test from *Rose v. Commissioner*, which merges subjective profit intent with objective economic reality. The court found the AEL program was a tax shelter with no realistic chance of profit. The McCrarys' claimed deductions were disallowed because the transaction lacked economic substance. The court rejected the McCrarys' argument that their subjective intent to profit should allow the deductions, finding their claim of profit intent not credible. The court upheld additions to tax for negligence and substantial understatement but not for valuation overstatement, following *Todd v. Commissioner*.

Practical Implications

This decision reinforces that transactions must have economic substance to generate tax benefits. Taxpayers cannot rely solely on subjective profit intent to sustain deductions from tax shelters. Practitioners must carefully scrutinize transactions for economic reality, not just potential tax benefits. The ruling may deter participation in tax shelters lacking economic substance. Subsequent cases have applied this principle to deny tax benefits for transactions lacking economic reality, even when taxpayers claim a profit motive.

© 2025 SCOTUSreports.com. All rights reserved.