Marine v. Commissioner, 92 T. C. 958 (1989)

Tax deductions claimed from sham transactions and transactions not engaged in for profit are disallowed.

Summary

James and Vera Marine invested in limited partnerships promoted by Gerald Schulman, who promised tax deductions equal to the investors' cash contributions through circular financing schemes. The Tax Court held that the partnerships' transactions, including the claimed first-year interest deductions, lacked economic substance and were shams, disallowing the deductions. The court also ruled that the partnerships were not engaged in for profit, and upheld additions to tax and additional interest due to the taxpayers' negligence and the tax-motivated nature of the transactions.

Facts

James and Vera Marine invested in Clark, Ltd. in 1979 and Trout, Ltd. in 1980, both limited partnerships organized by Gerald Schulman. Schulman promoted these partnerships as tax shelters, promising first-year interest deductions equal to the limited partners' cash contributions. The partnerships allegedly purchased post offices at inflated prices using nonrecourse financing, with no actual loans or interest payments. Schulman was later convicted of tax fraud related to these schemes. The Marines claimed substantial tax deductions based on the partnerships' reported losses, which were disallowed by the IRS.

Procedural History

The IRS issued a notice of deficiency to the Marines, disallowing their claimed partnership losses and asserting additions to tax and additional interest. The case proceeded to the U. S. Tax Court, where the Marines argued for theft loss deductions and the validity of their partnership losses. The court ruled against the Marines, upholding the IRS's determinations.

Issue(s)

1. Whether the Marines are entitled to theft loss deductions on their cash contributions to the partnerships.
2. Whether the partnerships' transactions had economic substance and were entered into for profit, entitling the Marines to deduct their distributive shares of the partnerships' losses.
3. Whether the Marines are liable for additions to tax under sections 6653(a) and 6661, and additional interest under section 6621(c).

Holding

1. No, because the Marines did not discover the alleged theft loss during the years in issue and the transactions did not constitute theft.
2. No, because the partnerships' transactions lacked economic substance and were not engaged in for profit, rendering the claimed deductions invalid.
3. Yes, because the Marines were negligent in claiming the deductions, and the transactions were tax-motivated, justifying the additions to tax and additional interest.

Court's Reasoning

The court applied the economic substance doctrine, finding that the partnerships' purchase prices for the post offices were grossly inflated and the financing arrangements were shams. The court referenced *Estate of Franklin v. Commissioner* to determine that the transactions lacked economic substance due to the disparity between the purchase price and the fair market value of the properties. The court also considered the absence of a profit motive under section 183, concluding that the partnerships' primary purpose was tax avoidance. The court rejected the Marines' arguments for theft loss deductions, noting that they received what they bargained for and did not discover any theft during the years in issue. The court upheld the additions to tax and additional interest, citing the Marines' negligence and the tax-motivated nature of the transactions.

Practical Implications

This decision underscores the importance of economic substance in tax transactions and the disallowance of deductions from sham transactions. It impacts how tax professionals should advise clients on investments promising large tax deductions, emphasizing the need for due diligence on the economic viability of the underlying transactions. The ruling also serves as a warning to investors to thoroughly investigate the legitimacy of tax shelters and the credibility of promoters. Subsequent cases involving similar tax shelter schemes have referenced *Marine* in disallowing deductions based on transactions lacking economic substance.

