Penrod v. Commissioner, 88 T. C. 1415 (1987)

The step transaction doctrine does not apply if shareholders did not intend to sell stock received in an acquisition at the time of the acquisition, even if they later sell it.

Summary

The Penrod family exchanged their stock in fast-food corporations for McDonald's stock in a merger. They later sold most of the McDonald's stock. The IRS argued the acquisition and sale should be treated as one transaction under the step transaction doctrine, failing the continuity of interest test. The Tax Court held the transactions should not be stepped together because the Penrods did not intend to sell the stock at the time of acquisition. The court found the acquisition qualified as a reorganization, allowing deferred recognition of gain. However, the court disallowed partnership loss deductions claimed by the Penrods due to insufficient evidence of their partnership interest.

Facts

The Penrod family owned stock in corporations operating McDonald's restaurants in South Florida. In May 1975, they exchanged their stock for McDonald's unregistered common stock. Jack Penrod, the family leader, negotiated the deal but did not request cash. The agreement included registration rights for the McDonald's stock. After the acquisition, Jack planned to open a competing restaurant chain called Wuv's. In January 1976, the Penrods sold 90% of their McDonald's stock. They also claimed partnership losses from an investment in NIDF II, a limited partnership, for 1976 and 1977.

Procedural History

The IRS determined deficiencies in the Penrods' income taxes, arguing the stock exchange did not qualify as a reorganization due to lack of continuity of interest. The Penrods petitioned the U. S. Tax Court, which held the acquisition was a reorganization and the subsequent sale should not be stepped together. The court also disallowed the claimed partnership losses.

Issue(s)

1. Whether the exchange of the Penrods' stock for McDonald's stock qualified as a reorganization under section 368(a)(1)(A) of the Internal Revenue Code.
2. Whether the Penrods were entitled to deduct their distributive shares of losses from NIDF II for 1976 and 1977.

Holding

1. Yes, because the Penrods did not intend to sell their McDonald's stock at the time

of the acquisition, maintaining the continuity of interest required for a reorganization.
2. No, because the Penrods failed to establish they were partners in NIDF II and thus not entitled to deduct the claimed losses.

Court's Reasoning

The court applied the step transaction doctrine to determine if the acquisition and subsequent sale should be treated as one transaction. It considered three tests: the binding commitment test, the interdependence test, and the end result test. The court found no binding commitment to sell the stock at the time of acquisition. Under the interdependence and end result tests, the court concluded the Penrods, particularly Jack, did not intend to sell the stock when they acquired it. Jack's plans for Wuv's were not contingent on selling the McDonald's stock. The court also noted the rising stock price and deteriorating relationship with McDonald's as factors influencing the later sale decision. Regarding the partnership losses, the court found the Penrods failed to provide sufficient evidence of their investment in NIDF II, rejecting their claims based on vague testimony and lack of documentation.

Practical Implications

This decision clarifies that for a reorganization to qualify under section 368(a)(1)(A), the continuity of interest test focuses on the shareholders' intent at the time of the acquisition, not their subsequent actions. It emphasizes the importance of factual evidence of intent, which may influence how reorganizations are structured and documented. The ruling also underscores the need for clear proof of partnership interests to claim tax deductions, affecting how partnerships are formed and managed. Subsequent cases have cited Penrod when analyzing the application of the step transaction doctrine in corporate reorganizations and the substantiation of partnership interests for tax purposes.

