Penrod v. Commissioner, T.C. Memo. 1988-548

The step transaction doctrine may be applied to collapse formally separate steps into a single transaction for tax purposes if the steps are interdependent and focused toward a particular end result, potentially negating the continuity of interest requirement for a tax-deferred corporate reorganization.

Summary

In 1975, the Penrod brothers exchanged stock in their McDonald's franchise corporations for McDonald's Corp. stock. Within months, they sold most of the McDonald's stock to fund a competing restaurant venture. The Tax Court addressed whether this stock exchange qualified as a tax-deferred reorganization under section 368, I.R.C., focusing on the continuity of interest doctrine and the step transaction doctrine. The court held that the reorganization qualified because the Penrods, at the time of the merger, intended to retain the McDonald's stock and their subsequent sale was due to changed circumstances, thus the step transaction doctrine did not apply. The court also disallowed partnership loss deductions due to insufficient proof of partnership investment.

Facts

The Penrod brothers (Jack, Bob, and Chuck) and their brother-in-law (Ron Peeples) owned several corporations operating McDonald's franchises in South Florida. McDonald's sought to acquire these franchises and proposed a stock-for-stock exchange to utilize pooling of interests accounting. The Penrods received unregistered McDonald's stock in exchange for their franchise corporations' stock in May 1975. The merger agreement included incidental and demand registration rights for the Penrods' McDonald's stock. Jack Penrod began planning a competing restaurant chain, "Wuv's," before the merger. Shortly after the merger, Jack actively developed Wuv's. By January 1976, the Penrods sold almost all the McDonald's stock received in the merger. The Commissioner argued the stock sale was pre-planned, violating the continuity of interest doctrine for reorganization.

Procedural History

The Commissioner determined deficiencies in the petitioners' federal income taxes, arguing the McDonald's stock exchange did not qualify as a tax-deferred reorganization and disallowing partnership loss deductions. The Penrods petitioned the Tax Court, contesting these determinations.

Issue(s)

1. Whether the exchange of Penrod corporations' stock for McDonald's stock qualifies as a tax-deferred reorganization under section 368, I.R.C. 1954.

2. Whether the petitioners are entitled to distributive shares of partnership losses

claimed for 1976 and 1977.

Holding

1. Yes. The exchange qualifies as a tax-deferred reorganization because the Penrods intended to maintain a continuing proprietary interest in McDonald's at the time of the merger, satisfying the continuity of interest doctrine. The step transaction doctrine does not apply.

2. No. The petitioners failed to sufficiently prove they were partners in the partnership from which the losses were claimed.

Court's Reasoning

Reorganization Issue: The court applied the continuity of interest doctrine, requiring shareholders to maintain a proprietary stake in the ongoing enterprise. The Commissioner argued the step transaction doctrine should apply, collapsing the merger and immediate stock sale into a single taxable cash sale. The court discussed three tests for the step transaction doctrine: the binding commitment test, the end result test, and the interdependence test. The court found no binding commitment for the Penrods to sell their stock at the time of the merger. Applying the interdependence and end result tests, the court determined the Penrods intended to hold the McDonald's stock at the time of the merger. Jack Penrod's plans for Wuv's existed before McDonald's initiated the acquisition. The Penrods' initial actions and statements indicated an intent to hold the stock. The court distinguished this case from *McDonald's Restaurants of Illinois v. Commissioner*, emphasizing the factual finding that the Penrods' intent to sell arose after the merger due to changed circumstances, not a pre-existing plan. The court stated, "*after carefully examining and evaluating all the circumstances surrounding the acquisition and subsequent sale of the McDonald's stock received by the Penrods, we have concluded that, at the time of the acquisition, the Penrods did not intend to sell their McDonald's stock and that therefore the step transaction doctrine is not applicable under either the interdependence test or the end result test.*"

Partnership Loss Issue: The court found the petitioners failed to prove they made capital contributions to the partnership (NIDF II) to substantiate their claimed partnership interests and losses. Testimony was unpersuasive, and documentary evidence was lacking or inconclusive. The court noted, "*the petitioners had the burden of proving that they made investments in NIDF II, and they produced only vague and unpersuasive evidence of such investments.*"

Practical Implications

Penrod v. Commissioner clarifies the application of the step transaction doctrine and continuity of interest in corporate reorganizations. It highlights that the shareholders' intent at the time of the merger is crucial. Subsequent stock sales shortly after a merger do not automatically disqualify reorganization treatment if the sale was not pre-planned and resulted from independent post-merger decisions or events. This case emphasizes the importance of documenting contemporaneous intent to hold stock received in a reorganization. It also serves as a reminder of the taxpayer's burden of proof, particularly in demonstrating partnership interests and losses, requiring more than just testimony without sufficient corroborating documentation. Legal practitioners should advise clients in reorganizations to maintain records demonstrating investment intent and to be aware that post-merger actions will be scrutinized to determine if the step transaction doctrine applies.

