94 T.C. 397 (1990)

Section 482 of the Internal Revenue Code does not mandate income allocation when an arm's length transaction between unrelated parties would result in zero rent due to prevailing market and business conditions.

Summary

Medford Associates (MA), a partnership, owned a golf course and leased it to Medford Village Resort & Country Club, Inc. (MVR), a corporation controlled by MA's partners. Due to operating losses, MVR paid no rent to MA. The IRS allocated rental income from MVR to MA under Section 482. The Tax Court held that no rental income should be allocated. Applying the arm's length standard, the court reasoned that an unrelated lessee, facing the golf course's financial history and market conditions, would have paid no rent during the years in question. The court emphasized that Section 482 aims to reflect true taxable income as if controlled entities were dealing at arm's length, and in this case, arm's length rent was zero.

Facts

Old Dutch, Inc. owned and operated the Sunny Jim Golf Club, which consistently lost money and went bankrupt in 1969. Medford Associates (MA), formed by petitioners, purchased the golf course in 1971. MA then formed Medford Village Resort & Country Club, Inc. (MVR), a corporation, and leased the golf course to it. The lease stipulated renegotiated rent, not less than $60,000 annually. However, due to operating losses and expenses paid to third parties, MVR paid no rent to MA from 1971-1979. The golf course was in a sparsely populated area with competition and had a history of losses and poor condition from prior bankruptcy.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in petitioners' federal income tax for 1976, 1978, and 1979, arising from adjustments made under Section 482. The Commissioner imputed rental income to Medford Associates from the corporation. Petitioners Joseph and Teresa Procacci, Michael and Frances Procacci, and Angelo Penza challenged these deficiencies in Tax Court.

Issue(s)

1. Whether a Section 482 adjustment is appropriate to allocate rental income from Medford Village Resort & Country Club, Inc. to Medford Associates.
2. If a Section 482 adjustment is appropriate, what is the proper amount of such adjustment?

Holding

1. No, because under the arm's length standard, an unrelated lessee would not

© 2025 SCOTUSreports.com. All rights reserved.

have paid rent under the circumstances.
2. Not applicable, because no Section 482 adjustment is warranted.

Court's Reasoning

The Tax Court applied the arm's length standard under Section 482, emphasizing that the goal is to place controlled taxpayers on tax parity with uncontrolled taxpayers. The court rejected both parties' attempts to establish per se rules. Petitioners argued that no allocation is proper if the lessee lacks funds after paying operating expenses, citing *Pitchford's, Inc. v. Commissioner* and *Johnson v. Commissioner*. Respondent argued that allocation is always proper if the lessee's gross income exceeds the imputed rent, citing *Thomas v. Commissioner*. The court clarified that these cases are fact-dependent and do not establish per se rules. The court found expert testimony from Cecil R. McKay, Jr., persuasive, who used the income approach to value golf course rentals, considering cash flow potential. McKay opined that fair rental value for the years in question was no more than $30,000, and potentially zero given expenses. Respondent's expert, Robert A. MacPherson, used a cost of reproduction approach, which the court deemed inappropriate for golf courses and factually baseless. The court concluded that based on the golf course's history of losses, poor condition, and market conditions, an unrelated lessee would have paid no rent. The court stated, "We are satisfied that no unrelated lessee could have been found who would have agreed to undertake such a project without substantial operating subsidies or other guarantees against loss."

Practical Implications

Procacci v. Comm'r clarifies that Section 482 adjustments must be grounded in economic reality and the arm's length standard. It highlights that imputed income cannot be created where no actual economic benefit would accrue in an arm's length transaction. This case is crucial for attorneys and tax professionals dealing with intercompany leases and transfer pricing, particularly in industries with volatile profitability or unique market conditions. It emphasizes the importance of economic substance and market-based evidence, such as expert testimony using income-based valuation methods, over formulaic approaches when determining arm's length considerations under Section 482. The case demonstrates that in certain circumstances, especially with distressed or unprofitable businesses, the arm's length rental rate can realistically be zero, negating the need for income allocation under Section 482.

© 2025 SCOTUSreports.com. All rights reserved.