Jacobson v. Commissioner, 96 T. C. 577 (1991)

A transaction structured as a contribution to a partnership followed by a distribution can be treated as a partial sale if it lacks a valid business purpose beyond tax avoidance.

Summary

JWC, fully owned by the Jacobsons and Larsons, transferred property to a new partnership with Metropolitan, receiving cash equal to 75% of the property's value. The Tax Court ruled this transaction was, in substance, a sale of a 75% interest in the property to Metropolitan, rather than a contribution followed by a distribution. This decision was based on the absence of a valid business purpose for the transaction structure, which was designed to avoid tax on the sale. Consequently, investment tax credit recapture was triggered for the portion of the property deemed sold.

Facts

JWC, a partnership owned by the Jacobsons and Larsons, sought to sell McDonald properties for two years. They formed a new partnership with Metropolitan Life Insurance Co. , contributing the properties subject to mortgages and receiving cash equal to 75% of the property's value, which was immediately distributed back to JWC. JWC reported this as a non-taxable contribution followed by a taxable distribution. The IRS argued it was a partial sale.

Procedural History

The IRS issued notices of deficiency to the Jacobsons and Larsons, treating the transaction as a partial sale. The taxpayers petitioned the U. S. Tax Court, which consolidated the cases. The court ruled in favor of the IRS, holding that the transaction was a partial sale.

Issue(s)

1. Whether the transfer of property to a partnership followed by a cash distribution should be treated as a contribution and distribution under IRC sections 721 and 731, or as a partial sale.
2. Whether and to what extent the taxpayers must recapture investment tax credits on the transfer of section 38 property to the partnership under IRC section 47.

Holding

1. No, because the transaction lacked a valid business purpose beyond tax avoidance, it should be treated as a partial sale.
2. Yes, because the portion of the property deemed sold triggers investment tax credit recapture under IRC section 47.

Court’s Reasoning

The court applied the substance over form doctrine, focusing on the economic reality of the transaction. It found no valid business purpose for structuring the transaction as a contribution and distribution rather than a sale. The court considered factors from Otey v. Commissioner, emphasizing the absence of a business purpose for the chosen form. The transaction’s structure was seen as an attempt to avoid taxes, with the cash distribution equal to 75% of the property’s value being disguised sale proceeds. The court also noted that the taxpayers were effectively relieved of 75% of the mortgage debt, further supporting the sale characterization. Regarding the investment tax credit, the court held that the portion of section 38 property deemed sold did not qualify for the “mere change in form” exception under IRC section 47, thus triggering recapture.

Practical Implications

This decision underscores the importance of having a valid business purpose when structuring transactions to avoid tax. Taxpayers must be cautious when using partnerships to defer gain recognition, as the IRS and courts will scrutinize such arrangements. The ruling impacts how similar transactions should be analyzed, requiring a focus on economic substance over form. It also affects legal practice by emphasizing the need for careful tax planning and documentation of business purposes. Businesses should be aware that structuring transactions to avoid taxes may lead to recharacterization as sales, with potential tax liabilities and recapture of investment tax credits. Subsequent cases have followed this precedent, reinforcing the need for genuine business reasons behind partnership transactions.

