Walt Disney Inc. v. Commissioner, 97 T.C. 221 (1991)

Transfer of Section 38 property between members of a consolidated group during a consolidated return year does not trigger investment tax credit recapture, even if a subsequent planned transaction results in the property leaving the consolidated group shortly thereafter, provided the steps are legally distinct and have independent economic significance.

Summary

Walt Disney Inc. (petitioner), successor to Retlaw Enterprises, challenged the Commissioner's determination of investment tax credit recapture. Retlaw transferred assets with unexpired useful lives to its newly formed subsidiary, Flower Street, and then distributed Flower Street stock to Retlaw shareholders, immediately before Walt Disney Productions acquired Retlaw stock. Retlaw and Flower Street filed a consolidated return for the period including the asset transfer. The Tax Court held that the transfer from Retlaw to Flower Street, within a consolidated group, did not trigger investment tax credit recapture under consolidated return regulations, and the step transaction doctrine did not override this provision.

Facts

Walt Disney Productions (Productions) sought to acquire certain assets of Retlaw Enterprises (Retlaw), specifically the "Disney assets" (commercial rights to "Walt Disney" name and Disneyland rides). Productions did not want Retlaw's "non-Disney assets" (TV stations, ranch, agricultural properties). To facilitate the acquisition, Retlaw agreed to transfer the non-Disney assets to a newly formed subsidiary, Flower Street, and distribute Flower Street stock to Retlaw shareholders before Productions acquired Retlaw stock. On December 1, 1981, Retlaw transferred the non-Disney assets (Section 38 property) to Flower Street in exchange for stock. Retlaw and Flower Street filed a consolidated tax return for the period ending January 28, 1982. On January 28, 1982, Retlaw distributed Flower Street stock to its shareholders, and immediately after, Productions acquired all of Retlaw's stock.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Retlaw's federal income tax, asserting investment tax credit recapture due to the asset transfer to Flower Street. Walt Disney Inc., as successor in interest to Retlaw, petitioned the Tax Court to challenge this determination.

Issue(s)

1. Whether the transfer of Section 38 property from Retlaw to its wholly-owned subsidiary, Flower Street, during a consolidated return year, triggered investment tax credit recapture under Section 47(a)(1).

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2. Whether the step transaction doctrine should apply to disregard the consolidated return regulations and treat the asset transfer as part of an integrated transaction resulting in recapture.

Holding

1. No, because Treasury Regulation § 1.1502-3(f)(2)(i) explicitly states that a transfer of Section 38 property between members of a consolidated group during a consolidated return year is not treated as a disposition triggering recapture.
2. No, because the steps taken (asset transfer and stock distribution) were not meaningless or unnecessary, had independent economic significance, and the consolidated return regulations explicitly exempt intercompany transfers from recapture.

Court's Reasoning

The court relied on Treasury Regulation § 1.1502-3(f)(2)(i), which provides an exception to investment tax credit recapture for transfers of Section 38 property within a consolidated group. The court emphasized the regulation's plain language and illustrative examples, noting that they directly contradicted the Commissioner's position. The court quoted from the regulation: "a transfer of section 38 property from one member of the group to another member of such group during a consolidated return year shall not be treated as a disposition or cessation within the meaning of section 47(a)(1)."

Regarding the step transaction doctrine, the court found that each step had independent economic significance. The transfer of assets to Flower Street separated the Disney and non-Disney assets, serving a valid business purpose even absent the subsequent stock distribution. The court stated, "Even apart from the shortcomings inherent in respondent's necessarily vague articulation of the step transaction doctrine in the instant case, we believe the record is sufficient to establish the independent significance of the steps questioned by respondent." The court distinguished prior cases where the step transaction doctrine was applied, finding no meaningless or unnecessary steps in this case. The court also highlighted the taxpayer's adherence to the consolidated return regulations, stating, "when a taxpayer adheres strictly to the requirements of a statute intended to confer tax benefits, whether or not steps in an integrated transaction, when the result of the steps is what is intended by the parties and fits within the particular statute, and when each of the several steps and the timing thereof has economic substance and is motivated by valid business purposes, the steps shall be given effect according to their respective terms."

Practical Implications

This case reinforces the validity and taxpayer-favorable application of consolidated

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return regulations, specifically § 1.1502-3(f)(2)(i), regarding investment tax credit recapture. It clarifies that intercompany transfers of Section 38 property within a consolidated group are generally protected from recapture, even in the context of broader transactions. The case limits the application of the step transaction doctrine when regulations provide explicit rules for specific transactions within consolidated groups. Taxpayers can rely on consolidated return regulations to avoid investment tax credit recapture in intercompany transfers, provided they comply with the regulatory requirements and the steps taken have independent economic substance and valid business purposes. This decision provides a clear framework for tax planning involving consolidated groups and asset transfers, emphasizing the importance of regulatory text over broader doctrines when specific rules are in place.

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