Roberts & Holland LLP

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More About Step Transactions: *G.D. Parker v. Commissioner*

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As the number of detailed statutory provisions designed to combat specific perceived tax abuses proliferates, it can be easy to lose sight of the continued importance of judicial principles, such as the step transaction doctrine, that have for decades been used by the Internal Revenue Service and the courts to deny to taxpayers the benefits that they have sought from tax-motivated transactions. A recent Tax Court memorandum decision, involving a taxpayer's effort to shift an unrealized capital loss from the taxpayer to a corporation that had recognized a large capital gain, so that the loss could be used to offset the gain, is an important and timely reminder of the continued vitality of the step transaction doctrine, even though the specific transaction at issue in that case is unlikely to be repeated in light of a statutory change that became effective in one of the years at issue.

G.D. Parker, Inc. v. Commissioner[1]

G.D. Parker, Inc. (petitioner), a Florida corporation incorporated by Genaro Delgado Parker, a citizen of Peru, served as a holding company for Mr. Parker's interests in businesses located in the United States and for property not used to a substantial degree in any business. Mr. Parker owned the stock of petitioner through a Panama corporation, Vilanova, S.A. (Vilanova).

Petitioner and its three wholly owned subsidiaries, each a Florida corporation organized in 1996 or 1997, formed an affiliated group with which petitioner filed a consolidated return for Federal income tax purposes. Vanini Investments, Inc. owned two homes used by Parker and members of his family as personal residences; Stella-Mar, Inc. owned a yacht; and G. D. P. Investments, Inc. (GDP) owned partnership interests in two partnerships, each of which owned a marina in Florida.

Mr. Parker also owned all the stock of another Panama corporation, Vicmar S.A., which in turn owned stock of Telemovil, S.A., a Peru telecommunications company (Telemovil) organized by Mr. Parker in 1990. Telemovil changed its name to Tele2000, S.A. in 1993, and was a publicly traded company on the Lima Stock Exchange.

GDP sold its entire partnership interest in one of the two marinas in 2003, resulting in the recognition of approximately $10.7 million of gain. Approximately $3 million of that gain was reported in 2003, and the balance of $7.7 million was to be reported by GDP in 2004 under the installment method. When an accountant and attorney at the accounting firm that provided tax return preparation and tax planning services to Mr. Parker told him, on September 1, 2004, that the affiliated group would owe Federal income tax on approximately $7 million of gain in 2004, Mr. Parker indicated that it was an inopportune time to pay so much tax.

About two weeks later, the accounting firm provided a memorandum to Mr. Parker that described a plan whereby Vilanova, the sole shareholder of petitioner, would contribute to petitioner shares of stock with a built-in loss in a transaction intended to be within the scope of IRC § 351, with the intent that the loss, when recognized, would offset the gain reportable by GDP on its 2004 return. The memorandum also indicated that the petitioner's loss deduction might be disallowed if there was no legitimate business purpose for the contribution of the stock with a built-in loss; and that there was then a legislative proposal pending to limit the transfer of built-in losses (through the contribution of property to a corporation) that might cause the loss to be disallowed, if the proposal were implemented with an effective date preceding the date of contribution of the asset with the built-in loss to petitioner.

Section 362 of the Internal Revenue Code was in fact amended about a month later to limit the importation of losses by means of a foreign contributor's transfer to a domestic corporation of an asset with a tax basis in excess of fair market value;[2] the statutory amendment required that the basis of the con-

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tributed property in the hands of the transferee corporation be not greater than fair market value. The amendment was effective for transactions occurring after October 22, 2004.

Prior to October 22, however, efforts commenced to cause the transfer of shares of stock with a built-in loss to petitioner. Although Mr. Parker had previously sold to BellSouth most of the controlling interest that he and his controlled corporation, Vicmar, had owned in Tele2000, Vicmar had retained approximately 2% of the stock of Tele2000, in which it allegedly had a cost basis of approximately $12,700,000. In November, 2002, Vicmar transferred ownership of its Tele2000 shares to Vilanova (the sole shareholder of petitioner).

In March 2004, BellSouth agreed to sell its Latin American operations to Telefonica Moviles, S.A., a Spanish media conglomerate (Telefonica), including the stock owned by BellSouth in Tele2000 at the price of approximately 1.5 cents per share. (The sale by BellSouth closed on October 28, 2004.) Telefonica offered to purchase the stock in Tele2000 owned by Vicmar for essentially the same price, or a total of approximately $195,000.

On September 2, 2004, petitioner accepted Vilanova's offer to transfer its Tele2000 shares to petitioner as a contribution to capital. The transfer of the Tele2000 shares to petitioner was not evidenced by the issuance of a new stock certificate, or by any entry in the stock ledger of Tele2000, until December 21, 2004.

Meanwhile, on December 16, 2004, BellSouth, Tele2000, Telefonica, Mr. Parker, Vicmar, Vilanova, and petitioner entered into a share transfer and settlement agreement (with petitioner being added to this agreement "at the last minute," according to the opinion) whereby petitioner agreed to sell the Tele2000 shares to Telefonica at the 1.5 cents per share price at which Telefonica had purchased shares of the same company earlier that year (*i.e.*, approximately $195,000, minus certain expenses). The settlement included provision for the termination of a shareholder derivative suit that had been brought by Vilanova against Tele2000 and BellSouth earlier in December 2004, and BellSouth provided the further inducement to Mr. Parker and his controlled corporations of dropping claims it had asserted against them by reason of unpaid taxes of Tele2000.

The sale of petitioner's stock of Tele2000 was completed on December 23, 2004, with the net proceeds being paid not to petitioner, but, rather, to Mr. Parker. Petitioner claimed a loss of approximately $12,600,000 from that sale, and the loss was used: to offset the gain on the marina sale reported by petitioner on its 2004 return; as a carryback to 2003; and as a loss carryforward to 2005.

The IRS ultimately asserted tax deficiencies against petitioner for 2003, 2004, and 2005, on the basis of a number of issues. In regard specifically to the loss claimed from the sale of stock of Tele2000 by petitioner in 2004, the Service argued that the loss should be disallowed under a variety of alternative theories: under IRC § 362(e) (the anti-loss importation provision added to the Code in October 2004); under IRC § 482 (which grants the Service broad authority to reallocate income and deductions among related businesses under common control where needed to prevent tax evasion or to clearly reflect income); under the doctrine of *Commissioner v. Court Holding Co.*,[3] and because the transfer of the Tele2000 shares served no business purpose; and under the step transaction doctrine (discussed below). The IRS also asserted that the claimed tax basis of petitioner in the stock of Tele2000 had not been substantiated.

The court noted that, under the step transaction doctrine as established by numerous cases cited in the opinion, "a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes." It was also noted that courts have applied three alternative tests in determining whether the step transaction doctrine should apply: (1) whether, at the time the first step was entered into, there was a binding commitment to undertake the later step (the so-called "binding commitment" test); (2) whether separate steps constitute prearranged parts of a single transaction intended to reach an end result (the "end result" test); and (3) whether separate steps are so interdependent that the legal relations created by one step would have been fruitless without the completion of the series of steps (the "interdependence test").

The court's analysis focused on the "end result" standard for applying the step transaction, and concluded that, under this standard, the step transaction doctrine should apply to ignore petitioner's transitory ownership of the shares of Tele2000. The court concluded in particular that, once BellSouth and Telefonica had agreed in March 2004 to the sale of BellSouth's approximately 98% of the stock of Tele2000 at 1.5 cents per share (as part of a larger transaction), the remaining Tele2000 shares owned by petitioner would be nearly worthless to anyone other than Telefonica, and it was therefore a foregone conclusion that the Tele2000 shares of petitioner would be sold at that same price.

It was also apparent that Mr. Parker was aware of the negotiations between BellSouth and Telefonica and of Telefonica's desire to purchase the Tele2000 shares controlled by Mr. Parker. Thus, when the shares of Tele2000 were transferred to petitioner at some time between September 1 and the date of the sale to Telefonica on December 28, the court concluded that petitioner was acting as nothing more than a conduit, such that its ownership should not be respected for tax purposes.

Petitioner offered two alleged business purposes for the transfer of the Tele2000 shares to petitioner: that the contribution to petitioner and subsequent sale of the shares by it would provide petitioner with funds needed to build a 4G cellular network in cooperation with a Peruvian subsidiary of Vicmar; and that petitioner, as a U.S. company, was in a better position than its Panama shareholder to negotiate and/or litigate with BellSouth to maximize the value of the investment in Tele2000 shares. The court found that neither alleged business purpose had significant support in the evidence before the court.

Although the court acknowledged that the overall transaction—that is, the sale of the Tele2000 shares to Telefonica at 1.5 cents per shares—was supported by a business purpose and had real economic effect, and was not conceived for the purpose of tax avoidance, that did not preclude application of the step transaction doctrine to effectively disregard an intermediate step.

Having found that, for Federal income tax purposes, there was no transfer of the Tele2000 shares to petitioner at any time, the court concluded that it need not address the issue of whether section 362(e) would have applied to disallow the loss if petitioner had acquired ownership of those shares for federal tax purposes.

Observations

The court's decision on this issue does not seem surprising based on the totality of the circumstances described in the opinion, which also addressed other tax deficiencies indicative of a pattern of aggressive or unsupportable tax positions. It is noteworthy, though, that, even though the record seems to present a reasonable case that the petitioner had beneficial, if not record, ownership of shares of Tele2000 for almost four months, commencing well before there was a binding contract for the sale of the Tele2000 shares owned by petitioner or its parent, and at a time when there were apparently meaningful discussions between petitioner's affiliates and BellSouth as to whether litigation pending against affiliates of petitioner would be dismissed as a quid pro quo for the sale of the shares to Telefonica, the court decided to disregard the petitioner's apparent ownership as without meaning for tax purposes.

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1 TC Memo 2012-327 (2012).

2 The anti-loss importation rules set forth in IRC § 362(e) may also apply where the contributor is a U.S. person.

3 324 U.S. 331 (1945).