Originally published in the:
New York Law Journal ***February 28, 2024***

Tax Court Order Raises Substance-Over-Form Questions

By: Ezra Dyckman and Charles S. Nelson

Whether an LLC is treated as a partnership or a disregarded entity for federal income tax purposes can sometimes have a significant effect on the tax consequences of a transaction. A recent order issued by the Tax Court in *Joint Star Properties, LLC v. Commissioner* (January 22, 2024) illustrates the sorts of issues that can arise.

If an LLC has a single member, then it is generally disregarded as separate from its member for income tax purposes, and if an LLC has more than one member, it is generally treated as a partnership for income tax purposes (assuming in each case that the LLC has not elected to be treated as a corporation).

Under IRS Revenue Ruling 99-5, if a person buys a portion of an interest in an LLC that is treated as a disregarded entity immediately before the sale, then for income tax purposes, the buyer is treated as purchasing an undivided interest in each of the LLC's assets, and the buyer and seller are then treated as contributing their undivided interests in the LLC's assets to a new partnership. The new partnership's tax basis in the assets deemed contributed by the buyer is equal to the purchase price, and its holding period with respect to the assets deemed contributed by the buyer begins as of the date of the sale.

In contrast, if a person buys an interest in an LLC that is treated as a partnership immediately before the sale, then, for income tax purposes, the buyer is simply treated as purchasing a partnership interest. Although the buyer's share of the LLC's tax basis in its assets is sometimes adjusted to reflect the purchase, the LLC will retain its prior holding period in its assets.

In *Joint Star Properties, LLC v. Commissioner*, Perry Pines, LLC had purchased land in Florida in 2008. On December 20, 2017, Perry Pines, LLC contributed the land to a newly formed LLC, Taylor Limestone Mining LLC ("Taylor Limestone"), and was initially its sole member. On December 21, 2017, Perry Pines, LLC contributed a 1% interest in Taylor Limestone to a wholly owned corporation. On the same day, Perry Pines, LLC sold a 99% interest in Taylor Limestone to a third-party purchaser. Immediately thereafter, Taylor Limestone contributed a portion of its land to a new LLC, Joint Star Properties, LLC, and distributed the membership interests in Joint Star Properties, LLC 99% to the buyer and 1% to the corporation. One week later, Joint Star Properties, LLC made a charitable contribution of a conservation easement on the land that it owned and claimed a charitable deduction.

When a taxpayer makes a noncash charitable contribution, the amount of the charitable deduction is generally equal to the contributed property's fair market value. However, the amount of the deduction is reduced by the amount of gain the taxpayer would recognize that would not be long-term capital gain if the property were sold for its fair market value. Thus, if a taxpayer donates appreciated property that it has held for one year or less, the taxpayer's charitable deduction would generally be limited to the amount of its tax basis in the property.

Joint Star Properties, LLC presumably claimed a charitable deduction with respect to the conservation easement that was significantly larger than its tax basis in the land. Thus, the amount of the deduction depended on whether it had a long-term holding period in the land. If Perry Pines, LLC had contributed a 1% interest in Taylor Limestone to its wholly owned corporation prior to the sale of the 99% interest, then Perry Pines, LLC would be treated as a partnership immediately prior to the sale rather than as a disregarded entity. If this ordering of the steps were respected, then Joint Star Properties, LLC would have had a long-term holding period in its land, and would have been entitled to a charitable deduction equal to the easement's fair market value (assuming all other applicable requirements were met). If, instead, the transfer of the 1% interest in Taylor Limestone occurred after the sale of the 99% interest, then at the time of the sale, Taylor Limestone would have been a disregarded entity. Under Revenue Ruling 99-5, 99% of the land would have had a short-term holding period, and so the charitable deduction would have been limited to the property's tax basis.

The IRS had moved for summary judgment on the issue of whether Joint Star Properties, LLC had a short-term holding period, on the grounds that Revenue Ruling 99-5 applied and that the sale of the 99% LLC interest was substantively a sale of the land. The Tax Court denied the motion.

First, the court found that the documents supported the taxpayer's position that the transfer of the 1% interest in Taylor Limestone to the corporation occurred before the sale of the 99% interest. Thus, Taylor Limestone was an existing partnership at the time of the sale of the 99% interest, and so Revenue Ruling 99-5 did not apply.

Second, the court refused to rule at the summary judgment stage that the transaction was in substance a sale of the land rather than a sale of a partnership interest. A long line of case law permits courts to re-characterize the form of a transaction to match its substance. However, the Tax Court held that this was an inherently factual inquiry that was not appropriate to decide on summary judgment.

It is far from clear that a re-characterization of this transaction is appropriate under the substance-over-form doctrine. While the taxpayer ordered the transaction steps to achieve a better tax result, the reordering the steps does not necessarily better reflect the economic substance of the transaction or result in a simplification of the steps. At the end of the day, the buyer and the corporation owned partnership interests, not the underlying land, and the Internal Revenue Code clearly permits an existing partnership to retain its holding period in property even when a third-party has purchased a partnership interest.

It will be interesting to see how this case is ultimately resolved. The IRS has been very hostile to conservation easements, which may explain the government's strategy in this case. However, the substance-over-form principles at issue are relevant to many other transactions.

Ezra Dyckman and Charles S. Nelson *are partners at Roberts & Holland LLP.*