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U.S. Tax Court: Option granted to related entity with respect to real property not a sham

The U.S. Tax Court yesterday released a memorandum opinion rejecting the IRS' contention that the taxpayer engaged in a sham transaction and wrongly assigned $4.2 million of income to a related entity under an option granted to the entity with respect to real property.

The case is: *Parkway Gravel, Inc. v. Commissioner,* T.C. Memo 2024-59 (May 21, 2024). Read the Tax Court's opinion

Summary

The taxpayer acquired a 58-acre parcel of land in 1966 that it used over the next few decades as a borrow pit to supply material for road construction. After it had outlived its usefulness, materials and waste that had been dumped there were removed and the site was filled in and brought to a grade where the land could be developed.

The taxpayer began exploring sale of the land in 2006 and identified a developer interested in purchasing the property if it could be rezoned. That same year, the taxpayer granted an option to purchase the land at its appraised value with its current industrial use zoning ($6.9 million) to a related partnership, which shifted any gain from a sale above the appraised value from the taxpayer to the related partnership.

The taxpayer and the related partnership entered into a sales agreement with the developer in 2007 to sell the property to the developer for $17,895,000, which was contingent on the property being rezoned from industrial to commercial use and the necessary approvals for development of the property as a shopping center or a mixed-use project. The sale agreement allocated $6.9 million of the purchase price to the taxpayer and the remainder to the related partnership.

Following a lengthy process of attempting to obtain the rezoning and necessary approvals for developing the property, the developer walked away from the sales agreement in 2012. However, the taxpayer ultimately secured the rezoning and approvals that same year, and the taxpayer and the related partnership reached a new sales agreement with the developer to purchase the property for $11.1 million. Under the sales agreement, the developer paid $6.9 million to the taxpayer and $4.2 million to the related partnership, in recognition of its interest in the property under the option granted in 2006.

The IRS contended that the $4.2 million allocated to the related partnership was improper and that the full sale amount must be recognized as income by the taxpayer. In particular, the IRS argued that the option agreement was invalid because it lacked consideration, that the related partnership served as a mere conduit for the sale of the property, and that the option agreement was a sham transaction.

The court rejected all of the IRS' arguments, finding that the option agreement was supported by valid consideration because the related partnership had undertaken significant efforts to rezone the property and thereby increase its value and marketability. The court also found that the transaction had a legitimate business purpose and economic reality, primarily due to the related partnership's active and substantial involvement in the rezoning and sale of the property.

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