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Arguing Against Your Own Form

By Robert W. Wood • Wood LLP • San Francisco

We've all been there. You do a transaction one way and after the fact think you should have gone a different direction. You may not want to undo the deal entirely. (Though on that topic, *see* the article on rescission in this issue.)

Still, you wish you had accomplished the transaction another way. Perhaps we are talking sale or liquidation, merger or consolidation, forward versus reverse or something else. But the end would be the same, let's assume, so the question is just how much flexibility you feel.

Can you report it as if you had done it that way? Can you, in the context of an audit or IRS dispute, argue successfully that the fact you could have done it one way means you should be allowed to treat it that way? These may sound like silly questions but they may not be, at least not in all circumstances.

Indeed, sooner or later, everyone at one time or another probably wants to disavow the form of a transaction that has already been consummated and seek to restyle it somehow. You may toy with the thought or you may go for the gusto and actually try it. But can you?

Difficult in the Extreme

As a general principle of U.S. federal income tax law, it is very difficult for a taxpayer to disavow the form of a transaction. That is true as a general matter and is even more true when the form was selected by the taxpayer to achieve tax benefits. This latter point is easy to understand. It actually looks untoward to try it.

For example, in *Nat'l Alfalfa Dehydrating & Milling Co.*, SCt, 417 US 134 (1974), the taxpayer argued that it should be entitled to deduct debt discount on debentures that it issued in exchange for its outstanding preferred shares. Perhaps that doesn't seem like a stretch. However, the Supreme Court thought it was.

The high court held that a deduction for debt discount was only allowable when the debt was issued for *cash* and not for property. The Court explained:

ALSO IN THIS ISSUE

> [W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not. [*Id.*, at 148.]

In a way, you might think of this as the reverse of Judge Learned Hand's famous aphorism about ordering your affairs to minimize taxes. You are free to do it, of course, but once you do it especially if you are doing it to save one tax you can't later change your mind because the tax result you picked was not the best one. In general, taxpayers face a heavy burden in arguing against their own form, particularly when they are doing so because, in hindsight, a different route would provide more advantageous tax consequences.

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Loans and the Like

To take another example, consider *Leavitt Est.*, CA-4, 875 F2d 420 (1989). There, the taxpayers were shareholders in an S corporation. As all tax professionals know, an S corporation makes an election to be treated as a passthrough entity similar to the partnership. The taxpayers provided personal guarantees on a loan made by a bank to the S corporation.

The taxpayers argued that, in substance, the guarantee transactions constituted constructive loans by the bank to the shareholders. As a consequence, the taxpayers contended that they had increased basis in their stock of the S corporation. After all, they argued, they were really the lenders to their S corporation rather than the bank.

They relied upon Internal Revenue Code Section ("Code Sec.") 1366(d)(1), which provides that shareholders have basis for indebtedness of the S corporation to the shareholder. If they had increased basis in their stock, they would have been able to claim increased losses. That sounded logical and is a theory many taxpayers have tried.

Yet in rejecting the taxpayers' argument, the Fourth Circuit explained:

> Generally, taxpayers are liable for the tax consequences of the transaction they actually execute and may not reap the benefit of recasting the transaction into another one substantially different in economic effect that they might have made. They are bound by the "form" of their transaction and may not argue that the "substance" of their transaction triggers different tax consequences. [*See supra*, 875 F2d, at 423.]

The taxpayers argued that the guarantees constituted constructive loans because the S corporation lost money. Had the S corporation been profitable, the shareholders would surely have argued in favor of the form. Otherwise, the payment of interest by the S corporation would have constituted constructive income to the shareholders.

There is a particularly high burden on taxpayers to argue against their own form when the taxpayer is arguing in favor of a more advantageous result in hindsight. In arguing against the form and in favor of the substance, the Fourth Circuit explained:

> [T]he burden is on the taxpayer and it has been a difficult one to meet. That is especially so where, as here, the transaction is cast in sufficiently ambiguous terms to permit an argument either way depending on which is subsequently advantageous from a tax point of view. *[Id.*, at 424.]

Capital Gain Too

In *B.D. Spector,* CA-5, 81-1 USTC ¶9308, 641 F2d 376 (1981), the taxpayer sold his accounting practice to another accounting firm. The transaction could have been structured either as (1) a sale of the seller's partnership interest in his firm, or (2) a two-step liquidation. The latter alternative would have first involved a merger of the seller's existing partnership into the acquirer's partnership followed by a liquidation of the seller's partnership interest into the acquiring partnership.

The simple sale of the seller's partnership interest would have resulted in the taxpayer being treated as recognizing a capital gain. However, the payments by the acquiring firm would not have been deductible. In the second and more complex scenario, the acquirer's payments to Spector would have been deductible as guaranteed payments under Code Secs. 736 and 707.

So what did the parties do? Under the merger agreement, the parties agreed to treat the transaction as a two-step liquidation. However, the taxpayer argued that because he was only nominally a partner in the newly merged partnership for three days, in substance, the transaction was a sale of his partnership interest.

It was presumably simply too tempting not to claim that capital gain, so Spector claimed it despite the form of the transaction. In holding against the taxpayer, the court noted that the IRS may, as a general rule, bind a taxpayer to the form in which the taxpayer has cast a transaction. [*See supra,* 641 F2d at 381.]

The court stated that a taxpayer would generally be bound to the form of the transaction unless he could demonstrate that a particular aspect of the transaction was not understood or bargained for as part of the overall transaction. Call it a mistake of fact or a mistake of law or perhaps some of each. But there must be something that moves a court to allow it and that will be tough.

Evidence of the true economic reality of a transaction would merely be relevant to determine if a given covenant or provision in an agreement was agreed, understood by both parties, given for value and bargained for at arm's length. Instead, a taxpayer may only challenge the form of a transaction on the basis that the agreement was unenforceable due to mistake, undue influence, fraud, duress, *etc*. [*Id.*, at 382 (*citing C.L. Danielson*, CA-3, 67-1 USTC ¶9423, 378 F2d 771, 775 (1967), *cert. denied*, 389 US 858 (1967)).]

All Is Not Lost

Despite the bleak picture in most of these cases, a taxpayer might be able to pull it off in the right circumstances. Taxpayers are able to challenge successfully the chosen form of a transaction only in unusual circumstances. One of the only extant examples is *R.H. Shulz,* CA-9, 61-2 USTC ¶9648, 294 F2d 52 (1961).

There, the taxpayer was able to argue against form and prevail. He established that he was an unsophisticated party unaware of the tax implications of a given allocation in the agreement. What's more, he established that the allocation did not correspond to the substance of the transaction. Meeting both of those key points, he won.

Sophisticated parties are unlikely to take much comfort in *Shulz*, though some will argue it. In general, it must be remembered, a taxpayer may only disavow the form of a transaction in rare and unusual circumstances.