In *Love*, Taxpayers Didn't Evade Taxes

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The tax code is full of provisions that are rarely discussed. Congress often endeavors to fill a particular tax loophole or bestow a particular tax incentive. Within a few years, though, the provision may be all but forgotten. Yet it stays in the Code like a dormant treat waiting to be rediscovered by taxpayers or the IRS at any time.

In some respects, Internal Revenue Code Section ("Code Sec.") 269 is this kind of provision, though it was never entirely forgotten. Still, it's a sleeper provision that is generally not argued by the IRS and generally not fretted over by taxpayers. It allows the IRS to disallow the tax impact of an acquisition when you've done it for tax avoidance.

That sounds pretty frightening, a kind of reverse Learned Hand notion that you should not be motivated by taxes, at least not entirely. In practice, though, the provision is largely ineffectual. A good example is *K.H. Love*, 103 TCM 1887, Dec. 59,088(M), TC Memo. 2012-166. There, the Tax Court held that a couple's acquisition of stock in a restaurant company couldn't be disallowed under Code Sec. 269.

The key to Code Sec. 269 is whether a principal purpose for the acquisition was the evasion or avoidance of income tax by securing the benefit of a deduction, credit or other allowance to which the taxpayer would not otherwise be entitled. If so, the IRS can disallow the deduction, credit or other allowance. "Principal purpose" means that the evasion or avoidance purpose must exceed any other purpose in importance.

In short, Code Sec. 269 requires a kind of comparative analysis. As the case law has developed, taxpayers have generally had an easy time showing that there were *other* reasons for a transaction outweighing tax avoidance.

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In the late '70s, Mark and Christine McCay were manager-trainees at McDonald's restaurants. They bought into several and eventually owned several of their own. In 1994, the McCays restructured by forming an operating company and a management company of which they were owners and officers.

The operating company ran the McDonald's restaurants and paid the franchise fees. The management company employed and paid all the employees. It was responsible for hiring, training and firing them. It also handled administrative duties.

The McCays formed a profit-sharing plan in 1994 for the benefit of the management company employees. However, in 2002, their tax and financial advisors told them that an ESOP would provide a more reliable source of income and benefits for management company employees, even providing them with an opportunity to obtain ownership interests in the management company.

Their legal and tax advisors said the ESOP-sponsoring management company should be an S corporation. That way the management company's income would pass through. The ESOP would be the sole shareholder but would not be taxed because it was tax-exempt. Finally, the advisors suggested a nonqualified deferred compensation plan for the management company.

The McCays did all this in 2002. They and their 275 other employees became ESOP participants and beneficiaries. The management company also established and began sponsoring a nonqualified deferred comp plan for senior officers and employees. Under it, from 2002 to 2004, the McCays deferred $3,066,000 of their new management company salaries. No other employees participated.

Because of the large amounts of deferred compensation, however, significant portions of the new management company's income were not distributed to the ESOP and to the other employee-beneficiaries. As a result, the stock in the new management company owned by the ESOP had little value. In January of 2004, the McCays' attorney sent them a letter addressing the new temporary regulations on ESOPs that covered esoterica such as synthetic equity and deferred compensation.

These rules implemented Code Sec. 409(p), which generally limits tax benefits available through ESOPs that own S corporations unless the ESOPs actually provide meaningful benefits to rank-and-file employees. It may have been nice while it lasted, the lawyers seemed to say, but this arrangement couldn't last. After weighing their options and consulting with accounting and legal advisors, the McCays took action.

They terminated the deferred comp plan and the ESOP and returned to a management company-sponsored profit-sharing plan. So in July of 2004 the McCays purchased the company stock from the ESOP. They then re-established a plan for the benefit of company employees, merged the ESOP assets into it, and terminated the ESOP.

Before the effective date of the regulations, the McCays were paid their deferred compensation, which they reported as ordinary income on their 2004 return. But this too had a thoughtful tax angle. Under Code Sec. 1377(a)(2), they elected to divide the management company's 2004 S corporation tax year in two—something permitted to S corporation shareholders when a majority of the stock changes hands.

During the first tax period, the ESOP was the sole shareholder of the new management company. The McCays were the sole shareholders during the second. The deferred compensation payment was made during the second, so the company was entitled to a deduction when the McCays were paid.

The resulting loss flowed through to the McCays and offset most of their deferred compensation income. The McCays also transferred $2,965,000 to the new management company as a capital contribution during the second period. That amount increased their stock basis and allowed them to take advantage of the loss deduction.

In short, this was a nicely orchestrated transaction from start to finish. Unfortunately, the IRS didn't think so. It determined that the acquisition from the ESOP of the stock in the new management company occurred for the principal purpose of avoiding or evading taxes.

As a result, the IRS disallowed the claimed $2,969,000 loss deduction under Code Sec. 269. In Tax Court, the McCays argued that Code Sec. 269 was never even intended to apply to S corporation stock acquisitions. Besides, their principal purpose here was to respond to the requirements of the pending temporary regulations!

To the IRS' chagrin, the Tax Court agreed with the McCays. Sure, there was some pretty aggressive tax planning going on, the court observed. But the McCays had legitimate nontax business reasons for purchasing the stock. In fact, the IRS seemed to be hoist by its own petard.

The temporary regulations *required* them to take *some* sort of action, said the court. Among the business reasons were that the overall structure had become more complicated and costly than originally anticipated. Plus, the McCays viewed the temporary regulations as imposing further complications.

It might seem there was double dipping here, but the court said the $3,066,000 payout of deferred compensation was *also* a direct response to the temporary regulations. This payout produced the tax deduction for the management company and was a substantive economic event for both the McCays and the company. In addition, the decision to bifurcate the 2004 tax year was appropriate in light of the ownership change and clearly authorized under Code Sec. 1377(a)(2).

The McCays' capital contribution increased their stock basis and reflected a real economic outlay. The fact that the contribution was also made with an eye towards increasing their bases and claiming the loss didn't alter the economic substance of the contribution.

Nicely done!

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