No Tax Avoidance by Taxpayers in *Love*

By Robert W. Wood


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Robert W. Wood is a tax lawyer with a nationwide practice (http://www.WoodLLP.com). The author of more than 30 books, including *Taxation of Damage Awards & Settlement Payments* (2009 with 2012 supplement, http://www.taxinstitute.com), he can be reached at Wood@WoodLLP.com. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Tax consequences may always be on people's minds, but they rarely want to say they did something primarily for tax reasons. Section 269 allows the IRS to disregard acquisitions if the principal purpose was tax avoidance. Wood looks at the IRS's lack of success in this area, particularly in the recent *Love* decision.

The tax code is notoriously bloated, full of provisions that are rarely discussed. One reason is that Congress often endeavors to fill a particular tax loophole or bestow a particular tax incentive and needs a code section to do it. Within a few years, however, 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 when it's needed most.

Section 269 was never entirely forgotten but is largely a sleeper provision. Generally, it is not argued by the IRS and is not worried about by taxpayers. A kind of *in terrorem* provision, it empowers the IRS to disallow the tax effect of an acquisition made for purposes of tax avoidance. The threat of not getting tax benefits based on a bad intent (and who hasn't had a bad intent about something once in a while?) is meant to be ever-present. Apart from the statute, the regulations help out on this topic, too.

Indeed, reg. section 1.269-3(b) expands on the statute. It ascribes a putatively bad purpose when an acquisition fosters tax benefits. One example is when a corporation with profits acquires control of a corporation with net operating losses and the acquisition is followed by asset transfers from the acquirer to the target that generate deductions to offset income. That course of action *ordinarily* will indicate a principal purpose to avoid tax.

That sounds pretty frightening, but in practice the provision is largely ineffectual for the IRS. There are usually nontax reasons that can explain an acquisition to the satisfaction of the courts, and sometimes even to the satisfaction of the IRS, rendering section 269, if not a dead letter, then at least a distant also-ran. A good example of why is *Love v. Commissioner*.[1]

In *Love*, the Tax Court held that a couple's acquisition of stock in a restaurant company was aggressive tax planning but couldn't be disallowed under section 269. Of course, the key to section 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 it is, the IRS can disallow the deduction, credit, or other allowance. "Principal purpose" in the context of section 269 means that the evasion or avoidance purpose must exceed any other purpose in importance. In short, there is a kind of comparative analysis at play.

As the case law has developed, taxpayers generally have had an easy time showing that there were other reasons for a transaction that outweighed tax avoidance. One indication of just how ineffective section 269 has been for the IRS over the years is demonstrated by the history of professional corporations. The IRS attempted to assert section 269 in a host of cases. In nearly every one, despite rather dramatic and obvious incidents of tax avoidance objectives, the IRS failed to achieve its desired goals.

[1]T.C. Memo. 2012-166, *Doc 2012-12731*, *2012 TNT 115-7*.

The IRS then prevailed upon Congress to enact section 269A to specifically target professional corporations in a more mechanical enforcement vehicle. That provision similarly failed to deliver the goods. Then there are the NOL restrictions under section 382.

Section 382 went through its own machinations. There were several statutory versions, even one that was repealed before it was ever implemented. Section 382 provides complicated rules governing the extent to which NOLs can be used by the acquirer after an acquisition. One would think that this specific NOL statute with its technical percentage tests and its interest rate calculations would be the single system of regulation for NOL acquisitions.

Nonetheless, the IRS has argued for the application of section 269 and, with or without section 382, has generally failed with its section 269 arguments. A good example is *Plains Petroleum Co. v. Commissioner*.[2] There, the taxpayer was a recent spinoff from KN Energy. Plains announced its acquisition plans in its first post-spinoff annual report.

Plains indicated that it would vigorously pursue acquisitions in order to replace its reserves and diversify its operations. During 1986 it considered more than 40 acquisition targets but was unsuccessful in acquiring them given its strict acquisition criteria. Also, shortly after its organization, Plains's management began considering a holding company structure. In due course, management concluded that such a structure would be best for its needs.

In October 1986 Plains was offered the opportunity to acquire Tri-Power, an entity with characteristics that fit Plains's acquisition guidelines. Tri-Power also happened to have NOLs totaling $84 million. Plains engaged Arthur Andersen to not only verify Tri-Power's reserves, but to also review Tri-Power's tax returns and verify the existence of the NOLs.

Shortly thereafter, Arthur Andersen issued a favorable opinion. Plains's management was fully aware that pending legislation (the Tax Reform Act of 1986) would limit its ability to exploit Tri-Power's NOLs if the acquisition was not consummated before 1987. The transaction closed, and on December 1, 1986, Plains transferred all its oil and gas properties to Tri-Power, which was then its wholly owned subsidiary.

Over the ensuing years, the income from the transferred properties was offset by Tri-Power's NOLs. In fact, Plains was able to avoid paying *any* federal income taxes for its 1987 through 1993 tax years because of the substantial Tri-Power NOLs. Plains's acquisition of control of Tri-Power and the subsequent asset drop-down fell squarely within the ''normal indication'' of tax avoidance described in reg. section 1.269-3(b).

Nevertheless, the Tax Court concluded that tax avoidance was not the principal purpose for the acquisition. As a result, the court held that section 269 did not disallow the use of the NOLs. Of course, this case involved the pre-TRA 1986 version of section 382. It seems unlikely that the IRS would have needed section 269 with the current harsher version of section 382.

In any event, in *Plains Petroleum* the IRS argued that the mere fact that Plains was aware of Tri-Power's NOLs was enough to import a tax avoidance purpose. The Tax Court wouldn't have it. The court was similarly unimpressed with the IRS's argument that Plains purchased Tri-Power's reserves at an excessive price, suggesting that the excess was actually paid to secure Tri-Power's favorable tax attributes.

You Deserve a Break Today

The petitioners in *Love*, Mark McKay and Christine Beck-McKay, were manager-trainees at McDonald's restaurants in the late 1970s. They bought into several franchises and eventually had their own restaurants. In 1994 the couple restructured their operations 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 the employees. It also handled administrative duties associated with administering employee healthcare and maintaining liability insurance.

The McKays formed a profit-sharing plan in 1994 for the benefit of the management company employees. However, it did not perform well over the years. In 2002 the couple's tax and financial advisers told them that an employee stock ownership plan 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 itself.

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

[2]T.C. Memo. 1999-241, *Doc 1999-25118, 1999 TNT 142-67.*

The McKays did all this in 2002. They and their 275 employees became ESOP participants and beneficiaries. The new management company also established and began sponsoring a nonqualified deferred compensation plan for senior officers and employees. Under it, from 2002 to 2004, the McKays deferred $2,965,000 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 or to the other employee-beneficiaries. As a result, the stock in the new management company owned by the ESOP had little value. In January 2004 the McKays's attorney sent them a letter addressing the new temporary regulations on ESOPs that covered esoterica such as synthetic equity and deferred compensation.

Those rules implemented section 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 for a time, the lawyers seemed to say, but this arrangement couldn't last. After weighing their options and consulting with accounting and legal advisers, the McKays took action.

They decided to terminate the deferred compensation plan and the ESOP and to return to a management company-sponsored profit-sharing plan similar to what they had before. So in July 2004 the McKays purchased the company stock from the ESOP. They then reestablished 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 McKays were paid their deferred compensation, which they reported as ordinary income on their 2004 return. But this, too, had a thoughtful tax angle. Under section 1377(a)(2), the couple elected to split the management company's 2004 S corporation tax year — 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 McKays were the sole shareholders during the second period. The deferred compensation payment was made during the second period, so the company was entitled to a deduction when the McKays were the sole shareholders.

The resulting loss flowed through to the McKays and offset most of their deferred compensation income. The couple 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 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 section 269. In the Tax Court, the McKays contended that section 269 was never intended to apply to S corporation stock acquisitions. Besides, they argued, their principal purpose here was to respond to the requirements of the pending temporary regulations.

To the IRS's chagrin, the Tax Court agreed with the McKays. Sure, there was some pretty aggressive tax planning going on, the court observed. But the court found that the couple had legitimate nontax business reasons for purchasing the stock in the management company in July 2004. In fact, the IRS seemed to be hoisted by its own petard.

The temporary regulations required the McKays to take *some* sort of action to avoid adverse tax consequences that otherwise would be triggered, said the court. Among the business reasons were that the overall structure had become more complicated and costly than originally anticipated. It was also less effective. Moreover, the McKays viewed the temporary regulations as imposing further complications.

Since it might seem as if there was double dipping here, the court found it telling that the $3,066,000 payout of deferred compensation was also a direct response to the temporary regulations. That payout produced the tax deduction for the management company and it represented a substantive economic event for both the McKays and the company. Also, the decision to split the 2004 tax year was appropriate in light of the ownership change and was clearly authorized under section 1377(a)(2).

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