WSJ Article on Recent Tax Court Case Doesn't Tell the Whole Story

LARRY E. AUSTIN AND BELINDA AUSTIN, Petitioners v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

In an opinion filed December 16, 2013, the United States Tax Court considered the tax effects of a 1998 transaction in which an ESOP acquired 100% ESOP of an S corporation which had restricted stock outstanding that could potentially dilute the ESOP ownership by 95%.

Holding: On a motion for summary judgment by the IRS, the Tax Court held that the employment related restrictions attached to the taxpayers' stock could create a valid "substantial risk of forfeiture" under Section 83 of the Internal Revenue Code of 1986, as amended ("IRC"), even though the IRS regulations under IRC Section 83 generally do not recognize a "for cause" termination of employment forfeiture clause as creating a substantial risk of forfeiture.

Procedure: The case will now presumably proceed to trial and consider additional arguments of the IRS attacking the position that the ESOP was the only shareholder for tax years 2000 – 2003.

Facts: In 1998, two individuals Mr. Austin and Mr. Kechijian created a new S corporation and transferred their business into the S corporation in exchange for restricted stock that represented 95% of the outstanding shares. At the same time, a newly formed ESOP acquired the other 5% of the S corporation's shares by issuing a promissory note to the Company. The taxpayers' intent was for their 95% interest to be treated as "not outstanding" for S corporation purposes, leaving the ESOP as the only shareholder for income tax purposes.

Each shareholder signed an employment agreement and a restricted stock agreement committing themselves to work exclusively for the Company through January 1, 2004, and to develop the business. The agreements provided an employee could be terminated "for cause" and defined "for cause" as follows:

> *A. Dishonesty, fraud, embezzlement, alcohol or substance abuse, gross negligence or other similar conduct on the part of the Employee. Upon termination of this Agreement, Employee shall be entitled to receive compensation through the date of termination.*
> *B. Failure or refusal by Employee, after 15 days written notice*

to Employee, to cure by faithfully and diligently performing the usual and customary duties of his employment and adhere to the provisions of this Agreement.
*C. Failure or refusal by Employee, after 15 days written notice to Employee, to cure by complying with the reasonable policies, standards and regulations applicable to employees which * * * [Company] may establish from time to time.*

The Agreement provided that if an employee was terminated for cause prior to January 1, 2004, the Company would buy his shares of stock back at between 0 -50% of fair market value.

The taxpayers took the position that their restricted stock was subject to a substantial risk of forfeiture under IRC Section 83. They then argued that since none of the restricted stock was outstanding for S corporation purposes, the ESOP's stock represented 100% of the outstanding shares for the period 2000-2003. The individuals did not report as income any portion of the S corporation's earnings for those tax years. On audit, the IRS took the position that the restricted stock was substantially vested for Section 83 purposes, thus making the individuals the 95% owners of the S corporation for tax purposes. Deficiencies for tax liability were asserted.

The taxpayers created a hurdle for themselves by using the term "for cause" because the Section 83 regulations provide that the risk of termination for cause will generally not create a substantial risk of forfeiture. However, the Tax Court examined the detail of the forfeiture provision, particularly paragraph B noted above, and concluded that the employee-shareholders could be terminated for unsatisfactory performance of their duties, a much lower standard than commonly associated with the term "for cause."

The Tax Court held against the IRS on its summary judgment motion, but acknowledged that the IRS had additional arguments it would hear at trial on the question of whether the forfeiture provision would create a real risk of forfeiture (including the fact that h two shareholders controlled the board of directors).

Observation: Effective March 14, 2001, IRC Section 409(p) effectively eliminated the possibility of structuring an ESOP transaction in the manner described in this case. While the outcome of the case will be of interest to those structuring equity compensation plans under Section 83, it will only be of historical interest to ESOP companies and their advisors.

If you are interested in learning more about the permitted uses of ESOPs and S corporations, we would be delighted to hear from you.