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THE M&A Tax Report

VOLUME 16, NUMBER 9
APRIL 2008

THE MONTHLY REVIEW OF
TAXES, TRENDS & TECHNIQUES

Forced Buyout Gain

By Robert W. Wood • Wood & Porter • San Francisco

Do you have gain even if a sale is not voluntary? Such questions rarely arise, although historically, they have sometimes come up with antitrust divestiture decrees. More recently, the Ninth Circuit Court of Appeals faced such an argument in *G. Hightower*, CA-9 (unpublished opinion), 2008-1 USTC ¶50,185 (2008). In fairness, though, most of this case was about timing, about *when* a sale occurred rather than *if* it occurred. This case involved a closely held S corporation and its two shareholders, Hightower and O'Dowd, who each owned 50 percent of a software concern.

According to their shareholders' agreement, any dispute would be resolved by binding arbitration. Notably, either of them could compel a buyout of the other's stock at a formula price. As sometimes happens in 50-50 partnerships, relations soured. O'Dowd triggered the buy-sell agreement, offering either to sell his shares for $47 million, or to buy Hightower's shares for the same price. O'Dowd compelled a buyout. Hightower demanded arbitration, but O'Dowd prevailed.

Accordingly, Hightower received a check for approximately $41 million in 2000. Hightower deposited it in an interest-bearing account, but didn't report the payment (or any of the interest for that matter) on his 2000 federal income tax return. Instead, Hightower proceeded to court, seeking to have the arbitration award set aside. In fact, he lost in court, and appealed to the state's Supreme Court, which declined to hear the case in 2003.

Taxable Gain?

Recently, we covered the claim of right doctrine, noting that it has long been one of the threshold questions one encounters with respect to inclusions of gross income. [*See* Robert W. Wood, *Cleaning Up Environmental (and Other) Cleanup Expenses* via *Claim of Right?* M&A Tax Report, Feb. 2008, at 4.]

Here, you have to give the taxpayer credit for raising a plethora of arguments. His view was that this was fundamentally a forced sale, and

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that even though he may have received payment in tax year 2000, he disputed the sale. Indeed, he asserted that he held it in trust in a segregated account while the dispute raged. As a technical matter, this argument took several guises.

Hightower argued that he was holding the O'Dowd payment in trust in a segregated account. The Tax Court disagreed. Hightower argued he involuntarily received the funds, and unconditionally renounced his right to them by creating a separate account.

Again, the Tax Court disagreed. It noted that Hightower had voluntarily cashed the check. He intended to return the funds, found the Tax Court, only if he succeeded in rescinding the buyout. Hightower also argued that this was an incomplete transaction because he tendered his shares to O'Dowd without endorsing the certificates.

Yet, the arbitrator of the dispute, and even the state courts to which Hightower had resorted when he lost the arbitration, had found that the stock was purchased in 2000. In fact, the Tax Court concluded that even if the payment to Hightower violated state law, a later determination to that affect would not absolve Hightower from his tax liability in the year of receipt.

The claim of right doctrine comes up in this case too. Under the claim of right doctrine, a payment is includable in income in the year in which the taxpayer receives it under a claim of right, even if that claim is disputed by another party. Arguing claim of right lore, Hightower claimed that his gain on the forced sale of shares should not be taxed. The claim of right doctrine focuses on whether a payment is received without restriction as to its disposition.

Here, whatever Hightower may have wanted to argue, this money was unrestricted. It was Hightower who tried to gin up arguments that he had held the money in abeyance. O'Dowd plainly considered the sale entirely finished. The state courts ultimately did too.

Any Sale Is a Sale

Notwithstanding all of Hightower's arguments, the Ninth Circuit concluded that the stock payment was taxable income in 2000. After all, it was received without restriction as to disposition, and it was clear Hightower had no fixed legal obligation to restore the funds to any other party. That clearly was an unavoidable decision here.

Notably, this conclusion was not altered by the fact that it remained possible during the years in question that a state court would later unwind the transaction. Hightower did argue about that, and it remained a possibility that one of the state courts would have heard his arguments.

Unfortunately, though, a taxpayer's unilateral intent not to claim and exercise dominion over the funds was simply not enough to affect his tax liability. For federal tax purposes, this transaction was done in 2000, even if a subsequent court might have undone the sale.

Interestingly, Hightower argued that the transaction left the company with a negative net worth, and that violated state law. The Tax Court and the Ninth Circuit didn't think much of this argument, but it is an interesting one from a contractual point of view. Ultimately, it did not impact the substantial cash payment

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THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

Hightower received in tax year 2000, whatever impact it might have had under state law.

Adding Insult to Injury?

Because this company was an S corporation, there was also a share of flow-through income allocated to Hightower in tax year 2000. The Tax Court and Ninth Circuit had to face the question of that pass-through distributive share of income. Hightower argued that his role in management was restricted, but the court correctly noted that was irrelevant under the S corporation rules.

Hightower had retained the beneficial ownership of his 50 percent of the stock through the sale date, so he had to pick up his share of the income. Hightower had claimed that the arbitration award had effectively divested him of beneficial ownership of his shares as early as 1998. While arguing in the alternative is a lawyer's (and taxpayer's) prerogative, one can't help thinking that Hightower was trying to have it both ways here. He ended up not having it either way, though he did get to keep his $41 million!

Escrow Rules

It's worth pondering as you review the inevitable result in Hightower whether there was another way to skin this particular cat. There may not have been. Still, one of the points that should come to mind is the taxation of escrow funds. If it had been possible to structure all or a part of this transaction as an escrow, the result might have been different. Here at the M&A Tax Report, we recently surveyed the landscape of escrow accounts and their taxation in M&A deals, and that survey is worth reviewing. [*See* Gerson & Alioto, *The Taxation of Escrow Funds: Part I,* M&A Tax Report, July 2007, at 1; and Gerson & Alioto, *The Taxation of Escrow Funds: Part II,* M&A Tax Report, Aug. 2007, at 1.]

Although escrowed stock or sale proceeds are often in a kind of legal limbo, where there is an escrow, there are usually two key tax issues. First, will the amount deposited in the escrow be immediately taxable to the target shareholders, or will the escrow amount instead be considered deferred consideration that could later be reported (by the seller) under the installment method? Second, which party (buyer or seller) will be responsible for tax on the income earned on the funds while in the escrow?

As Gerson and Alioto point out in their escrow fund survey, usually buyer and seller will try to address these issues in the documents, so taxpayers, their lawyers and accountants, and even the IRS, have a clear roadmap. Admittedly, the lore of escrows may not be terribly helpful in a situation like Hightower's where the buyer considers the transaction a done deal, but the seller disputes not merely a piece of the transaction, but rather the entire deal.