Beware Gifts Before Business Sale

By Robert W. Wood • Wood LLP • San Francisco

The Bible suggests it is better to give than to receive even when you give up a lot. With today's tough economy, some might dispute whether it is better to be donor or donee. That can be particularly true when it comes to taxes, which have a funny way of turning sensible things on their heads. They can sometimes even make you wish you could take a gift back.

That's what happened in *J.L. Miller*, TC Memo. 2011-189, where the Tax Court considered a father who gave most of his stock to his son the prior year. That was good for estate planning. It also seemed like good income tax planning, since the father was in the process of selling the company and wanted his son to benefit from owning the shares.

Often one sees owners of family companies give shares away right before a sale. The idea is typically to get the family members some cash on the sale and have them taxed at their own rates on the gain. But there was one slight problem in the case of Miller's company: It was an S corporation.

Of course, S corporations are generally taxed not at the entity level but at the shareholder level by reference to stock basis. The magnanimous father here hadn't calculated his basis carefully and had actually transferred to his son the majority of his stock basis along with the stock. That meant the father ended up with a big tax bill he would not have faced had he not given the stock away.

Basis and Gifting Shares

S corporation shareholders take into account their *pro rata* share of the S corporation's items of income, loss, deduction or credit. A shareholder's basis is increased by income passed through to the shareholder and decreased by, among other items, distributions not includable in the shareholder's income. [*See* Code Sec. 1367.] The amount of a distribution equals the cash plus the fair market value of property distributed.

If an S corporation has no accumulated earnings and profits, the amount distributed reduces the shareholder's basis in his stock. If the amount exceeds basis, the excess is treated as a payment in exchange for the stock. Thus, distributions are not included in a shareholder's gross income if they do not exceed the adjusted basis of the shareholder's stock. Any distribution in excess of basis is treated as gain from the sale or exchange of property.

Doesn't all this sound simple? To tax professionals perhaps, but evidently not to Miller, who had owned all of the outstanding stock of JAM Pharmaceutical, Inc. That consisted of 10,000 shares of class A voting common stock, and 90,000 shares of class B nonvoting common stock.

Although JAM's certificate of incorporation was amended on August 29, 2002, to authorize the issuance of one million shares of each class, no additional shares were issued. On December 31, 2002, Miller's adjusted basis in his 100,000 shares was $866,795 (his original basis of $200,000 plus JAM's accumulated adjustment account balance of $666,795, as of December 31, 2002).

A purchase agreement dated December 12, 2002, executed by Miller and his son, stated that Miller agreed to sell 950,000 shares of his JAM stock (out of the one million issued and authorized to be issued) to his son for $95,000. The closing date wasn't identified. The agreement stated that the buyer's obligation to purchase was subject to conditions, including that (1) Miller would resign as JAM's director and officer on the closing date, and (2) all of the JAM shares would be sold concurrently to the buyer.

Subsequently, Miller transferred 5,000 shares of class A stock and 90,000 shares of class B stock to his son. His son did not pay his father $95,000 for the JAM stock, and Miller did not resign as a director and officer of JAM.

On his Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, for 2002, filed on July 24, 2003, Miller reported the transfers of JAM stock on December 31, 2002, to his son as follows: (1) 5,000 shares of class A stock in which Miller had an adjusted basis of $43,340 with the value of the gift as $34,600; and (2) 90,000 shares of class B stock in which he had an adjusted basis of $780,116 with the value of the gift as $511,200.

JAM's 2003 Form 1120S reported ordinary income of $366,162. On a Schedule K-1, *Shareholder's Share of Income, Credits, Deductions, etc.,* attached to the return, JAM reported that Miller owned five percent of JAM's stock during 2003 and that his share of JAM's ordinary income for 2003 was $18,308. On May 9, 2005, JAM filed an amended Form 1120S for 2003, which reported a $1,110,390 loss, with the Schedule K-1 for Miller reporting a $55,519 loss—*i.e.,* five percent of JAM's total loss.

Thereafter, the IRS determined that JAM had $382,452 of ordinary income and that Miller's distributive share was $19,123. In addition, IRS determined that the senior Miller had received $619,551 of distributions from JAM in 2003, $548,664 of which exceeded his basis in his JAM stock and was taxable as long-term capital gain.

To try to get around the basis problem, Miller argued that he didn't give the JAM stock to his son on December 31, 2002, but rather in 2003. Of course, he had listed the December 31, 2002, date of gift on his gift tax return! Miller also argued that he didn't *actually* give the JAM stock to his son and instead that it was part-sale and part-gift. The $95,000 purchase price should be treated as paid through the additional distributions he received from JAM in 2003, Miller argued.

The Court rejected Miller's argument that the gift of stock took place later than 2002. It was just too hard for Miller to explain away the gift tax return. Plus, no amended Form 709 was filed. Even worse, no gift was reported for 2003. But this wasn't all.

The stock certificate stubs listed December 31, 2002, as the date that 95,000 shares of JAM were issued to Miller's son. Plus, JAM's 2003 Form 1120S and Miller's individual income tax return reported him as having five percent of the shares. The court wasn't prepared to let Miller disavow his 2002 gift of 95 percent of the JAM stock to his son after he learned of the tax consequences.

The Tax Court also rejected the argument that the JAM stock transfer to his son was a part-sale and part-gift. The record didn't show sale, partial or otherwise. The terms of the purchase agreement did not reflect JAM's August 29, 2002, amended articles of incorporation authorizing one million shares each of class A and B stock.

In fact, JAM issued a total of 100,000 shares to Miller—not one million shares as the purchase agreement indicated. Further, Miller's son failed to pay the purchase price identified in the agreement and Miller failed to resign as this document seemed to require. Even more basically, Miller failed to report a sale of JAM stock on his 2002 or 2003 tax return.

Want to hear another Hail Mary argument? Miller argued that because JAM made disproportionate distributions during 2003, these disproportionate distributions should be recharacterized to treat the effective date of the transfers of JAM stock from Miller to his son as occurring after the disproportionate distributions. The court found that Reg. §1.1361-1(1)(2)(i), which explains that distributions that are different in timing may be equalized within a period of time to avoid violating the one-class-of-stock provision, did not support such a recharacterization.

Bitter Pill

Taxpayers are usually unsuccessful in arguing they documented something one way, but they *really* meant something else. The economic-substance and substance-over-form doctrines stand for the proposition that the IRS may be able to recast a transaction as what it was intended to accomplish. But taxpayers rarely can do the same.

Put another way, sometimes one is hoist by one's own petard. Here, the Tax Court concluded that Miller gifted the 95,000 shares to his son on December 31, 2002. That left him with a five-percent interest and an adjusted basis of $51,661. Accordingly, in 2003 he received distributions from JAM in excess of his basis and that produced a long-term capital gain.

What's the moral of the story? The father argued the documents were incorrect, that he gave the stock away but in January 2003 not December 2002. Oops—all the documents said 2002, and he even filed a gift tax return reporting the 2002 gift. The Tax Court didn't buy it or any of this other silly arguments. The moral?

When it comes to giving, get some tax advice *before* you act. Make your documents helpful and consistent. If you have to someday argue that you *really* meant something other than what you wrote, try to make the story convincing in both documents and testimony.

Reasonable Compensation Lore in the Modern Era (Part II)

By Robert W. Wood • Wood LLP • San Francisco

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Proportionality of Compensation

Another factor is the extent to which compensation is paid proportionate to share ownership. The nexus between ownership and payment is clear where compensation is in direct proportion to share ownership. Conversely, payments may look to be much less like dividends if they are out of proportion to share ownership and are related to other factors, principally the actual services performed and their benefits. [*See J.D. Kennedy, Jr.,* CA-6, 82-1 USTC ¶9186, 671 F2d 167 (6th Cir. 1982); and *Bank of Stockton,* 36 TCM 114, Dec. 34,237(M), TC Memo. 1977-24 (1977).]

Manner of Determining Payment

The manner in which the payment is determined is relevant in assessing whether it is compensation. If the extent of the payment is determined according to the overall results of the company, and without regard to the results achieved by the payee, the payment may be more likely to be treated as a dividend. [*See Paul E. Kummer Realty Co.,* CA-8, 75-1 USTC ¶9262, 511 F2d 313 (1975); and *Nor-CaI Adjusters,* CA-9, 74-2 USTC ¶9701, 503 F2d 359 (1974).]

Timing of Payment

A large payment may be more likely to be justified as compensation if it is made at the end of the year. At that time, results of operations are known and compensation can be more fairly determined. However, this can backfire.

Year-end is also the time when the results of corporate operations are available and an inference of dividend payment may result. [*See Petro-Chem Marking Co.,* CtCls, 79-2 USTC ¶9484, 602 F2d 959 (1979); *Owensby & Kritikos, Inc.,* 50 TCM 29, Dec. 42,133(M), TC Memo. 1985-267 (1985).] An important factor here, as in the entire reasonable compensation area, is to maintain appropriate documentation. If possible, show the basis for the compensation, specific actions that justify it, comparable levels of compensation in other companies and other data that offer evidence of reasonableness.

Nonshareholder Salary Scales

The fact that nonshareholders receive a certain compensation level for similar work, perhaps even as high as that paid to shareholders, is highly relevant in assessing whether an asserted compensation expense deduction should be allowable. [*See Central Freight Lines, Inc.,* 35 TCM 85, Dec. 33,639(M), TC Memo. 1976-25 (1976).] However, where the services provided by the nonowner employees are not comparable in scope or quality to the services provided by the owner employees, the relevance of compensation paid to the nonowner employees is not high. [*See R. Clymer, Jr.,* 47 TCM 1576, Dec. 41,152(M), TC Memo. 1984-203 (1984); and *Lundey Packing Co.,* 39 TCM 541, Dec. 36,462(M), TC Memo. 1979-472 (1979).]

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General Salary Scales

Salary scales are relevant from two perspectives. One is simply the salary scale of the particular company for all employees. A generous salary scale for nonemployee owners (and for employees in general) may help to disprove that compensation to employee/shareholders is a disguised dividend. [*See Home Interiors & Gifts Inc., supra.*] The salary scale in the industry as a whole is relevant in determining whether compensation is reasonable under the circumstances. [*See* Reg. §1.162-7(b)(3).]

Qualifications of Employee

The qualifications of the employee are clearly relevant in assessing the reasonableness of

compensation. [*See Kennedy, supra;* and *Dahlem Foundation, Inc.*, 54 TC 1566, Dec. 30,272 (1970), *acq.*, 1971-1 CB 2.] A highly qualified employee may be paid more than a minimally qualified one.

Corporate Formalities

The extent to which compensation is payable pursuant to formal corporate agreements is also important. A detailed employment or consulting agreement, corporate resolutions, provisions for bonuses and the like are all relevant. Nevertheless, their absence will not necessarily doom compensation to dividend treatment. [*See Mayson Manufacturing Co.*, CA-6, 49-2 USTC ¶9467, 178 F2d 115 (1949).] Moreover, some courts have viewed formal board resolutions as bearing little weight in the case of closely held corporations. [*See, e.g., Boyle Fuel Co.,* 53 TC 162, Dec. 29,815 (1969).] The safest course is still to pay compensation only pursuant to formal arrangements.

Past Compensation

Never underestimate the impact of a record of inadequate pay in the past. If a founder or other key person was paid inadequately for the last twenty years, a large payment can make up for it. Statistical information can help. Resolutions and agreements reciting the inadequate pay in the part can help materially to justify current pay.

Conclusion

Tax practitioners may only occasionally see these issues, but they are still very much alive. M&A TAX REPORT readers should be especially alert for situations in which outsize compensation is paid either before or after a takeover. In the public company context, we may see these issues as bearing solely on Code Sec. 162(m) performance-based pay and on the golden parachute rules. However, across the vast canvas of closely held businesses, the reasonable compensation doctrine is unlikely to go away.

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