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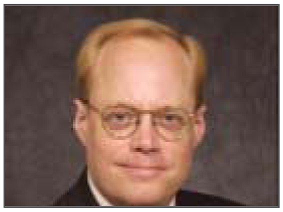

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THE TAX LAWYER

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Taxpayers In Love Couldn't Evade, Says Tax Court (Seriously)

(Image credit: Getty Images via @daylife)

The tax code is full of provisions that are rarely discussed. Congress often endeavors to plug a tax loophole or bestow a tax incentive, so enacts a new tax law to do it. Within a few years, the provision is all but forgotten.

Yet it stays in the code to be rediscovered by taxpayers or the IRS. Section 269 was never entirely forgotten, but it's a sleeper generally not argued by the IRS or fretted over by taxpayers. Enacted in 1954, it empowers the IRS to disallow the tax impact of an acquisition when you've done it for tax avoidance.

That sounds frightening, but in practice, is largely ineffectual. A good example why is *Love et al. v. Commissioner*. There, the Tax Court agreed that a couple's acquisition of stock in a restaurant was highly aggressive tax planning. Even so, the court ruled the deal couldn't be disallowed under Section 269.

Section 269 is triggered only if a principal purpose of an acquisition is tax avoidance by getting tax benefits you otherwise couldn't. If bad intent is present, the IRS can disallow your deduction, credit, etc. What's a "principal purpose?" Tax avoidance must exceed any other purpose in importance.

In the late ’70s, Mark and Christine McCay were manager-trainees at McDonald’s. They eventually had several of their own restaurants and their own management company. In 1994, they formed a profit-sharing plan but later switched to an Employee Stock Ownership Plan (ESOP), a special plan designed to invest in employer stock.

They also sponsored a nonqualified deferred compensation plan. In fact, from 2002 to 2004, they deferred over $3M of their pay and no other employees participated. They even personally claimed a tax loss when a payout triggered the loss. They split their tax year in two and when the amount was paid, contributed it to capital to increase their basis in their stock. Very, very slick.

The IRS denied the $3M loss claiming their acquisition of stock in the new management company from the ESOP was to evade taxes. In Tax Court, the McCays argued Section 269 was never intended to apply to S corporation stock acquisitions. Besides, they argued, their principal purpose was to respond to 2003 Treasury rules disallowing their deferred compensation. The court agreed and said Section 269 didn’t apply. Why?

In July 2004, the McCays had legitimate non-tax reasons to acquire the stock. Plus, the $3M payout of deferred compensation was a direct response to IRS’s rules. That produced the tax loss and had economic consequences for the McCays and the company.

In addition, their decision to split the 2004 tax year was legal in light of the stock ownership change. The McCays’ capital contribution reflected an economic outlay and legitimately increased their tax basis. The fact that the contribution was also made with an eye towards increasing their tax basis and claiming losses didn’t change that.

These taxpayers were well-advised, savvy and had good documentation. That’s true love.

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