TAX COURT CASE UPDATE

Citation:

Allen L. Davis, et al. v. Commissioner, T.C. Memo 2011-286, December 12, 2011.

Overview:

In a case involving a family-owned S corporation, disharmony among family members, and whipsaw[1] deficiency notices issued by IRS, the Tax Court has held that the family patriarch had income of $36,962,694 under Code Sec. 83(a) from stock he received on exercise of an option. It also held that the company could deduct this amount under Code Sec. 83(h).

The Facts:

The petitioners in this case are shareholders of CNG Financial Corporation, an S corporation, which operated a pay day loan business. The son, Jared founded the company is 1994 with the proceeds of a loan from his parents (Allen and Judith). In 1995, Jared's brother (David) and sister (Laura) acquired stock in the business, and David joined the company as an officer. In order to grow the business, CNG obtained various forms of financing from banks and Allen. In return for Allen's loans, he was provided with options to purchase 188.86 shares of stock from each of them (1997). Allen promised that he would not exercise these options unless he was in serious financial distress.

Also in 1997, the four family members entered into a stock transfer restriction agreement that in the event of certain attempted transfers of CNG stock, the agreement gave the other shareholders a right of first refusal to purchase the stock at net book value. The list of triggering events included a forced sale pursuant to a divorce decree or other legal process.

In 2000, Allen exercised the 1997 options, acquiring 23 percent of the outstanding shares of CNG. He entered into a voting trust agreement with Jared that enabled him to vote Jared's shares (33.5 percent interest). He tried to enter into a similar arrangement with David, but David refused. Allen used his majority control to remove David from the board and elect himself president, CEO and chairman of the board.

Subsequent, CNG entered into a credit agreement which required Allen to participate in the day-to-day management of CNG. It also required CNG to obtain an additional $10 million in financing from external sources, which was accomplished. Allen resigned as an officer of CNG at the end of 2000, but stayed on as a consultant through December 2004.

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[1] A "whipsaw" is often a situation where deficiency notices are issued to parties on both sides of a transaction who have treated the same item of the transaction inconsistently, typically including an item in income for one taxable entity and allowing a deduction for the other. The alternative position in each of the respective deficiency notices is that there is no income and no deduction. Ultimately, the deficiency falls upon the party that is unsuccessful. In this situation, the Commissioner is more like a stakeholder between the two parties.

In 2001, Judith filed for divorce claiming that she was entitled to 50 percent of Allen's shares in CNG. In an attempt to resolve the acrimonious divorce, Jared went into court claiming that the stock transfer agreement had been triggered and asking the court to force Allen to sell his shares to Jared at book value. Since this would have reduced the value of the marital estate, Allen and Judith ultimately settled their divorce.

The settlement included transferring half of Allen's shares to Judith, but allowing him to repurchase the shares for $16 million. CNG then redeemed the shares from Judith and amended the option to allow Allen to avoid paying any portion of the exercise price, but allowing him to receive a number of shares that were worth $16 million less. At the same time, Laura sold her shares to Allen. After the redemption, the number of outstanding shares was reduced and ownership was 37.85 percent each for Jared and Allen and 24.3 percent for David.

In 2004, CNG amended its credit facility. Fifty million dollars of the increase was for the purpose of a distribution to the shareholders. As part of this amendment, the covenant requiring Allen to be involved in the day-to-day management of the company was removed. Prior to the distribution, Allen exercised his cashless option and received an additional 131.8055 shares of CNG stock.

CNG treated the stock as compensation to Allen and deducted it from revenues lowering the net income reported on each shareholders' Schedule K-1. Allen did not treat the stock option exercise as income and did not include it on his tax return.

The question at trial was whether the exercise of this final option resulted in income to Allen, and if so, if any of that amount is deductible by CNG.

Discussion:

Under Code Section 83(a), when property is transferred in connection with the performance of past, present or future services, a taxpayer must include the excess of the property's fair market value over the amount paid for the property in gross income. In the case of options without a readily ascertainable fair market value, this code section applies to the stock received upon exercise of the options rather than at the time of receipt.

In this case, the parties argued over whether the stock was transferred in connection with the performance of services. Allen put forth various arguments contending that certain rules applied that indicated that the stock was not issued in connection with the performance of services. The Court disagreed with the arguments and moved forward to decide the case on the preponderance of the evidence.

The Court determined that based on the evidence, "Because CNG granted the Allen Option to secure Allen's participation in the management of the company, the stock Allen received by exercising that option was transferred in connection with the performance of services. Whether CNG had other reasons for granting the Allen Option does not alter that fact."

The next issue was the value of the stock to be included in Allen's income. The IRS and the CNG group contended that the value of the stock should be determined by the value of the cashless exercise provision ($16 million exercise price divided by the 57.0545 shares retained by CNG). Allen hired an independent appraiser who valued the shares at a value approximately $10 million less. The Court ruled that the value established by the cashless exercise provision

was a better indication because it represented an arm's length transaction between Allen and CNG. The Court also ruled that a discount for lack of marketability of 30 percent was not appropriate because the value of the shares was not determined by the use of publicly traded information.

Finally, The Court looked at whether the amount of compensation paid to Allen was reasonable (therefore, 100 percent deductible by the corporation on its 2004 tax returns). The Court ruled that although the family relationship between Allen and his sons invited careful scrutiny, this does not mean that the agreement was not at arm's length. In this case, the sons had an adverse interest to the father and therefore the option granted was negotiated at arms' length and was not a one-sided bargain.

The Court ruled,

> The option enabled CNG's expansion, and that expansion increased the company's revenues and income not only for the period the option was outstanding, but also for future years. Jared and David also benefited from the Allen Option because CNG's success increased the value of their ownership interests. Under the facts and circumstances of these particular cases, we find that Allen's 2004 compensation was reasonable and hold that CNG is entitled to deduct $36,962,694 as reasonable compensation to Allen in 2004.

Conclusion:

In a case evolving from family disputes, the IRS prevailed in showing that the father had exercised options that generated taxable income to him under Code Section 83 and deductible compensation to the corporation.