

TAX COURT CASE UPDATE

Citation:

Allen L. Davis v. Commissioner, 111 AFTR 2d 2013-1979, May 16, 2013.

Overview:

In a case involving a family-owned S corporation, disharmony among family members, and whipsaw deficiency notices issued by IRS, the 11th Circuit, affirming the Tax Court, has held that the family patriarch had income of \$36,962,694 under Code Section 83(a) from stock he received on the exercise of an option. It also held that the company could deduct this amount under Code Sec. 83(h).¹

The Facts:

In the original case, the father and his two sons took opposite positions. The father (Mr. Davis) did not include the value of the stock in income although the company deducted it (with the sons receiving the tax benefit as pass-through shareholders). To protect itself, the IRS issued whipsaw deficiencies stating that it was taxable to the father but not deductible by the company. Ultimately, the deficiency fell upon the father, as the unsuccessful party.

The IRS determined an over \$13 million deficiency with respect to Mr. L. Davis and an over \$4.7 million deficiency with respect to each of his sons, Jared and David, as well as a smaller deficiency with respect to an unrelated party. All of them were shareholders of CNG Financial Corporation (CNG), an S corporation. The controversy concerned an option that CNG granted to the father in 2002.

CNG operated a payday loan business through its subsidiary. Jared Davis founded CNG in 1994. His brother David Davis became a shareholder in 1995. In 1997, the brothers got cash from Mr. Davis to expand the business. In exchange for the cash, they each gave Mr. Davis options to purchase 188.86 shares of CNG stock (the 1997 options) from each of them. Mr. Davis promised David Davis that he would not exercise the 1997 options unless he experienced financial distress.

In 1997, the three Davis children (a sister also owned shares) and the father also entered into a stock transfer restriction agreement that, in the event of certain attempted transfers of CNG stock by a CNG shareholder, 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 January 2000, two years after retiring as President and CEO of Provident Financial Group, Mr. Davis exercised the 1997 options. He got majority voting control, removed David Davis from the board, and elected himself, president, CEO, and chairman of the board. Later that year,

¹ The citation to the original case was *Mr. L. Davis, et al. v. Commissioner*, T.C. Memo 2011-286, December 12, 2011.

CNG got a large line of credit from a bank syndicate. The credit was advanced, in part, because of Mr. Davis' experience at Provident and the bank group insisted on his continued involvement in the company.

Mr. Davis' wife filed for divorce in 2001 claiming that she was entitled to half of his shares. The divorce was acrimonious. Jared Davis got a court to agree that he could buy his father's shares at book value under the stock transfer restriction agreement. Because this would have reduced the marital estate, the parties agreed to a plan to resolve the conflict. Under this plan, Mr. Davis transferred half of his CNG shares to his estranged wife, subject to an option allowing Mr. Davis to repurchase the shares for \$16 million (the Judith Option). CNG then redeemed the 188.86 shares from the wife and amended the Judith Option (the Allen Option) by adding a cashless exercise provision. The cashless exercise provision allowed Mr. Davis to avoid paying any portion of the exercise price and to instead receive a number of shares (determined according to a formula) that were worth \$16 million less than the value of 188.86 shares. The Allen Option was not transferable.

In 2004, Mr. Davis exercised the Allen Option through the cashless exercise provision and received 131.8055 shares of CNG stock worth \$36,962,694. CNG treated the stock as compensation to Mr. Davis, and the other shareholders (collectively, the CNG parties) each claimed their share of the company's \$36,962,694 compensation deduction on their returns for 2004. Mr. Davis, on the other hand, did not treat the Allen Option's exercise as taxable and did not include the stock's value in his gross income for 2004.

The parties disagreed as to whether the CNG stock Mr. Davis received in 2004 was transferred in connection with the performance of services. The CNG parties argued that it was. Mr. Davis and the IRS argued that it was not.

The Tax Court found that the CNG stock was transferred to Mr. Davis in connection with his performance of services because CNG granted the Allen Option with the intention of securing Mr. Davis' participation in the day-to-day management of CNG. The Court then found the value of the shares that Mr. Davis received was \$36,962,694. Lastly, it held that, under Code Section 83(h), CNG could deduct \$36,962,694 as reasonable compensation to Mr. Davis in 2004.

Mr. Davis appealed the Tax Court's findings. To ensure consistent treatment of the transaction, the IRS appealed the Tax Court's decision with respect to the CNG taxpayers. Mr. Davis argued on appeal that the Tax Court erred in determining that the Allen Option was granted to him in connection with his performance of services and in valuing the shares he received upon the option's exercise.

Discussion:

The 11th Circuit determined that the Tax Court properly found that the Allen Option was granted to Mr. Davis in connection with his performance of services for CNG. The Appeals Court noted that Mr. Davis arranged for the creation of the Judith Option without Mrs. Davis' involvement, and that all of the parties knew that CNG would immediately cash-out her CNG shares and grant Mr. Davis an option to purchase shares directly from the company. Despite the form of the transaction, Mr. Davis never intended to exercise the Judith Option to purchase shares from Mrs. Davis; he intended to purchase shares from CNG. In reality, CNG, not Mrs. Davis, always bore the burden of providing Mr. Davis with additional shares when he exercised the option.

The record supported the Tax Court's finding that CNG granted the Allen Option to ensure his continued involvement with the company. Mr. Davis had conditioned his continued involvement in CNG's management on the receipt of an option to purchase shares to replace those he had to give to Mrs. Davis. CNG, believing his threats, granted the Allen Option in order to retain his services.

Mr. Davis did not dispute that CNG granted the option to him to ensure his continued involvement with the company. Rather, he asserted that the Judith Option, which, after amendment, became the Allen Option, served additional purposes, such as stabilizing control of CNG and resolving family strife. The 11th Circuit said that the Allen Option undoubtedly also provided these benefits. However, it stressed that the presence of additional benefits or motivating factors did not alter the nature of the option grant.

Mr. Davis contended that, because he received the Judith Option from Mrs. Davis, it could not have been in connection with the performance of services. The 11th Circuit disagreed. CNG was the de facto counter-party under the Judith Option and, more importantly, CNG granted Mr. Davis the Allen Option.

Mr. Davis also argued that Code Section 1041, providing for the non-recognition of gain on divorce-related transfers between spouses, shielded his exercise of the option from tax. The 11th Circuit disagreed. While the transfer of an option between spouses or former spouses incident to divorce is shielded by Code Section 1041, it said that exercise of an option is not.

Conclusion:

The 11th Circuit concluded that the Tax Court did not err in its valuation methodology. The Tax Court was tasked with valuing the shares Mr. Davis received in their cashless sale. It was reasonable for the Tax Court to use the parties' own valuation of the shares on the exercise date in assessing fair market value. Therefore, the Tax Court's valuation was not clearly erroneous and Mr. Davis should have included \$36,962,694 in ordinary income in 2004. Because of its finding as to the income taxable to Mr. Davis, the 11th Circuit also concluded that the CNG taxpayers' deductions were proper under Code Section 83(h).