TAX COURT CASE UPDATE

Citation:

K.H. Company LLC v. Commissioner, T.C. Memo 2014-31, February 24, 2014.

Overview:

In a declaratory judgment proceeding, the Tax Court has concluded that the IRS did not abuse its discretion in determining that an employee stock ownership plan ("ESOP"), established by a corporation that was later changed to an LLC taxed as a partnership, was not qualified under Code Section 401(a).

The Facts:

K.H. Company, LLC, a limited liability company, was the sponsor, employer, and administrator of the K.H. Co., LLC Employee Stock Ownership Plan, whose documents stated that it was intended to be an ESOP that would invest primarily in qualified employer securities.

Before October 6, 1994, K.H. Co. operated as K.H. Co., Inc., a corporation, which was the plan's original sponsor. On October 6, 1994, K.H. Co., Inc., began operating as K.H. Co., an LLC, which began filing partnership tax returns and whose members were Carol Tomb and the K.H. Co. Inc. Employee Stock Ownership Trust. For the years in question, Ms. Tomb was K.H. Co.'s only employee.

After conducting an examination, on January 26, 2006, the IRS proposed to disqualify the plan because: (1) the plan ceased to be a qualified ESOP when K.H. Co. became an LLC; (2) the appraiser of the plan assets was not a qualified independent appraiser, as required under ESOP rules; (3) the plan failed to allocate employer securities to individual participants' accounts, and thus failed to follow its own terms; and (4) the plan was not amended timely to reflect changes in certain statutory requirements. In March 2012, the IRS issued a final revocation letter, having determined that the plan failed to be qualified under Code Section 401(a) for the plan year ending September 30, 1995, and following years.

Ms. Tomb brought a declaratory judgment proceeding challenging the IRS's final revocation letter.

Discussion:

An ESOP must be designed to invest primarily in qualifying employer securities. The definition of qualifying employer securities includes stock (of certain specifications) that the employer has issued. The term stock is defined to include shares in an association, joint-stock company, or insurance company, and a corporation is defined to include associations, joint-stock companies, and insurance companies. On the other hand, the term partnership is defined to exclude a corporation.

Thus, the Tax Court said the term stock generally excludes partnership interests. K.H. Co. was a partnership for plan years ending September 30, 1995 and the years following, and accordingly did not have any stock. The court concluded that, because K.H. Co. had no qualifying employer securities in which the plan could invest, the plan had failed to operate as an ESOP according to its terms when K.H. Co. became the employer, sponsor, and administrator.

The IRS also contended that the plan's appraiser did not meet the ESOP requirements for an appraiser. Under the ESOP rules, an "independent appraiser" must perform all valuations of securities that are not readily tradable on an established securities market. The standards for such appraisers are similar to those set forth in the Code Section 170(a)(1) regulations. In particular, the IRS determined that the plan's appraisal summaries did not contain a declaration that the appraiser held himself out to the public as an appraiser, or performed appraisals on a regular basis, as specified in the regulations. Although the appraisal summaries stated that the "undersigned" held himself out as an appraiser, there was no signature below that statement or on any of the appraisal summaries.

In addition, the appraiser did not set forth his background, experience, education, and membership (if any) in professional associations, as the regulations required. The only statement that was set forth was that the "undersigned" was an accountant who was familiar with the assets being appraised.

The plan contended that the appraiser had degrees in English, accounting, and law, and that he had prepared appraisals of stock in ESOPs for many clients, for several years, and that he was the author of a book on ESOPs. Further, the plan claimed that the appraiser was "independent," as required by the code, the regulations, and the IRS’s rules. But, because there was no signature below the statement on the appraisal summaries, the court found that the plan had failed to meet the requirement for an independent appraiser. In addition, the court said that nothing in the administrative record corroborated the plan's claims regarding the appraiser's background.

The plan also argued that the appraiser had substantially complied with regulation section 1.170A-13 because the appraiser had not been a party in donor transactions involving the property being appraised, a donee of the property, or an employee of the donors or donees, and that he had prepared most of his appraisals for entities other than the plan. But the court said that the record did not contain support for the plan's contentions.

The IRS also determined that the plan contained disqualifying provisions because the plan had failed to be amended in a timely or proper manner to reflect changes made in the Code by legislation collectively referred to as "GUST." The IRS noted that the GUST legislation included changes related to: (1) cost-of-living adjustments on the elective deferral limits; (2) the change in the required beginning date for non-5-percent owners’ required minimum distribution rules; (3) the "primary direction and control test" employee leasing rules; (4) the rules for veterans; (5) the definition of compensation, which was amended to include tax-free employer contributions or deferrals under a Code Section 457 plan and/or qualified transportation fringes; and (6) the exclusion of hardship distributions from eligibility for rollover, and that the plan had not been amended to reflect any of these changes. But the plan contended that remedial amendments could have been made on a retroactive basis, to save the plan's qualified status.

However, the court pointed out that the so-called GUST remedial amendment period, which applied for making the amendments to qualify the plan on a retroactive basis because of the changes indicated, had expired on the last day of the first plan year beginning on or after January 1, 2001 which for the K.H. Co. plan was September 30, 2002. Although the IRS had received a submission for a favorable determination letter for the plan on January 9, 2003, this was too late to have extended the remedial amendment period, because the submission was made after September 30, 2002. Furthermore, while retroactive amendments to a qualifying plan are allowed in certain circumstances, under Notice 82-66, here, no corrective amendments addressing these plan defects had been made.

Conclusion:

The Tax Court concluded that the IRS had not abused its discretion in determining that the plan was not qualified for its plan years ending September 30, 1995, and for following years.