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CLIENT ALERT

Tax Court Applies the Economic Substance Doctrine in *Austin v. Commissioner*

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In *Austin v. Commissioner*, T.C. Memo. 2017-69, the Tax Court analyzed individual steps of a larger transaction to determine whether each step satisfied the business purpose and non-tax profit motive requirements of the economic substance doctrine.[1] The IRS attacked the transaction by arguing that various steps within the larger transaction lacked economic substance. This decision gives greater insight as to what factors a judge might consider in determining whether or not a transaction has legitimate business purpose or valid non-tax profit motive. In *Austin,* the IRS raised, and the court analyzed, four separate economic substance issues:

1. Did the creation of a holding company have economic substance?
2. Did the use of an employee stock ownership plan (ESOP), which resulted in substantial tax savings, have economic substance?
3. Did the sale of assets by the S corporation have economic substance?
4. Did the pre-arranged surrender and repurchase of stock, for the purpose of avoiding an inclusion in income pursuant to section 83, have economic substance?

Facts of the Case

Under the Small Business Job Protection Act of 1996, Congress allowed ESOPs to be eligible shareholders of S corporations. Because S corporations are pass-through entities and ESOPs are not generally subject to Federal income taxes, this structure can result in significant tax savings.[2]

Larry Austin and Arthur Kechijian (the petitioners) entered into a series of transactions to take advantage of the tax benefits of an S corporation/ESOP structure. First, in December 1998, the petitioners incorporated an S corporation to serve as a holding company for their pre-existing businesses (organized as corporations and limited liability companies). The petitioners' shares of the S corporation were subject to a five-year vesting period (vesting on January 1, 2004). Next, the petitioners created an ESOP for its employees. The ESOP owned five percent of the S corporation, with the petitioners owning the rest. Taking the position that all of their stock was subject to a "substantial risk of forfeiture" within the meaning of section 83, and therefore treated as not outstanding for purposes of the pass-through of S corporation income, the petitioners did not report any income from the S corporation on their 2000-2003 Federal income tax returns. During this period, the petitioners filed returns on the basis that a tax-exempt entity, the ESOP, owned all of the outstanding stock of the S corporation. Needless to say, structures like this, which were predicated on an ESOP being a permitted S corporation shareholder, attracted the attention of both Congress and the IRS.

In 2001, Congress amended the law (effective in 2005) to make ESOP ownership of an S corporation less desirable. No doubt anticipating that the change in law would be adverse to their interests, in late 2003, the petitioners reorganized their business.

The reorganization involved the sale of the S corporation's operating subsidiaries to a new LLC holding company (Holdings), which would thereafter conduct the business. As a result, the S corporation would recognize built-in gain and allocate 100 percent of that gain to the ESOP. Furthermore, the value of the ESOP would be frozen at the date of the sale. Holdings would receive a stepped-up basis on the transferred assets, and could claim future depreciation and amortization deductions.

Shortly after the petitioners' stock vested in 2004, they entered into an agreement to surrender and then immediately repurchase the stock using promissory notes. The petitioners took the position that despite the vesting of the stock in 2004, the surrender/repurchase transaction deferred any income recognition.

Creation of the S corporation holding company had a legitimate business purpose, and therefore, economic substance

Judge Lauber held that the creation of the S corporation to serve as a holding company had a legitimate business purpose. Consolidation of petitioners' pre-existing business under the S corporation resulted in reduced reporting requirements and allowed the subsidiaries to more easily transfer assets. It was immaterial that the subsidiaries had the same operations before and after the transfers to the S corporation, which the judge noted is true for any holding company structure. The opinion also stated that it did not matter that the petitioners intended to use the S corporation as part of a plan to achieve tax benefits. This favorable holding on the use of holding companies is sure to be frequently cited by taxpayers.

Formation of an ESOP to serve as an S corporation shareholder had economic substance

It was undisputed that Congress allowed ESOPs to be eligible shareholders of S corporations. However, the IRS argued that the ESOP was utilized entirely for the petitioners' tax avoidance plan, and that the petitioners could have utilized alternative options to incentivize and retain employees *(e.g.*, a 401k plan). The court was not persuaded by this argument, stating that the Code does not limit employers to a specific retirement incentive approach. The ESOP was properly created and funded, and used to benefit the company's eligible employees. Also, the ESOP was recognized as tax-exempt by the IRS for each of the years at issue.

As noted above, this particular structure resulted in the S corporation's income not being taxed at all. Having failed to mount a successful legal attack on this result, the IRS turned to economic substance as a last recourse. The Tax Court rejected this approach, noting that when the ESOP's shares were redeemed in 2004, the ESOP received more than $9 million in proceeds for the account of employees other than the petitioners. The Tax Court held that there was no "plausible argument" that an arrangement that enriched the employees participating in the ESOP by that amount lacked economic substance.

Furthermore, the IRS was unsuccessful in arguing that the ESOP was invalid due to technical compliance foot faults, which included filing wrong IRS forms and completing certain forms inaccurately or incompletely. The court stated that these foot faults are not relevant to the economic substance inquiry. The relevant inquiry is whether the formation and maintenance of the ESOP had economic substance and served a legitimate business purpose, which the court determined that it had.

Restructuring in response to a change in the tax laws had a legitimate business purpose

Next, the court considered the November 2003 sale of the S corporation's operating assets to Holdings. As discussed above, this sale was motivated by the effective date of the 2001 changes to the tax laws. Looking at the "real-world consequences" of the sale, such as the freezing of the ESOP's value, the court held that the sale of operating assets to Holdings had economic substance. Importantly, the court found that a restructuring in response to a change in law, while tax motivated, was a legitimate business purpose.

The pre-arranged surrender and repurchase of stock was solely tax motivated, and therefore, lacked economic substance

Lastly, the court considered whether the 2004 surrender and repurchase of stock lacked economic substance. As noted above, the stock received by the petitioners in 1998 vested in January of 2004. In March of 2004, the petitioners surrendered their stock to the S corporation for no consideration and immediately thereafter subscribed to buy essentially the same stock in exchange for notes. The Tax Court concluded that the surrender/repurchase transaction was motivated by no purposes other than tax avoidance. The only business purpose suggested by the petitioners was to avoid payment of employment taxes, which the court stated was in itself a tax-avoidance purpose. The court also held that there was no possibility of profit, because the petitioners wound up owing $41.5 million for no additional economic benefit. Although this post-mortem tax planning maneuver failed -- because the stock had vested a few months earlier -- the Tax Court also held that this surrender/repurchase transaction lacked economic substance.

Conclusion

The four economic substance arguments raised by the IRS are indicative of how the IRS uses this doctrine in litigation. The IRS evidently sees economic substance as an argument that is infinitely adaptable to the circumstances of any structure or transaction that it cannot attack using technical legal arguments. The Tax Court's thoughtful analysis reserves the economic substance doctrine for the only transaction that truly lacks economic substance.

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