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Ernst & Young: When Must Stock Be Taken Into Income?

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On May 23, 2000, the consulting business of Ernst & Young ("E&Y") was sold by E&Y and certain of its "accredited consulting partners" ("ACP's") to Cap Gemini, S.A. ("Cap"). Consistently with the form of the transaction and as required by the transaction documents, the ACP's reported their gain on the transaction as being fully taxable to them, almost entirely as a capital gain, during 2000.

Some of the ACP's, later regretting the results of that tax reporting, filed claims for refund with the Internal Revenue Service, asserting that the bulk of the gain should not be taxable until certain restrictions lapsed and that they had accordingly overpaid their income taxes for 2000. The IRS paid the requested refunds to those ACP's, but then began feeling regrets of its own, and commenced suit against the ACP's to require them to "refund the refunds." In two such suits, *United States v. Culp*, 99 AFTR 2d 2007-618 (M.D. Tenn. 2006), and *United States v. Fletcher*, 101 AFTR 2d 2008-588 (N.D. Ill. 2008), the Government has now prevailed.

This result is not especially surprising -- the taxpayers were seeking tax treatment different from that contemplated and agreed by the parties in the year of sale and reflected on their initial tax returns. Taxpayers are likely to encounter difficulties when they agree to report a transaction in one manner, but have second thoughts thereafter.

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Background

On May 23, 2000, in order to effect the sale of the consulting business of E&Y to Cap: (i) the consulting business was contributed to a newly formed Delaware limited liability company ("CGE&Y"); (ii) some of the interest of E&Y in CGE&Y was transferred to the ACP's; and (iii) E&Y and its ACP's transferred the entire interest in CGE&Y to Cap. The individual ACP's also received cash from E&Y in termination of their partnership interests in E&Y.

A description of the transaction that was circulated to the ACP's about two months before closing, as well as the transaction documents themselves, provided that each ACP would receive shares of Cap stock in exchange for the ACP's interest in CGE&Y. These documents stated that each ACP's gain on sale attributable to the receipt of the Cap shares would be reportable by the ACP in the year of the sale (2000), that it was anticipated that the gain would be taxed at a combined Federal and state rate of approximately 25%, and that the stock received by the ACP's would be valued, in computing the consideration for the sale, at 95% of the closing price of the Cap stock on the date of the sale.

One-fourth of the shares in Cap received by each ACP would be sold immediately after the closing of the sale, thereby providing the ACP with funds to pay the taxes on the transaction. The balance of the shares were deposited with a third party in a restricted account in the name of the ACP, and an irrevocable power of attorney was granted by the ACP to Cap to vest it with authority over the account for a period of four years and 300 days after the transaction closed. During that period, the shares could not be sold except in certain permitted transactions.

The ACP could vote the shares held in the restricted account for his or her benefit, but had no present right to receive dividends, which were apparently to be accumulated for the ACP's benefit.

Some or all of the shares held in the restricted account would be forfeited if: the ACP breached non-competition or certain other provisions of the transaction documents; the ACP voluntarily left CGE&Y; or the ACP was terminated by Cap "for cause" or for poor performance. The description of the transaction circulated by E&Y stated that all of the ACP's would "vest" in their Cap shares immediately upon the closing.

Consistent with the above, Cap issued a Form 1099-B to each ACP in early 2001, indicating gross proceeds to that ACP from the sale in 2000 of interests in CGE&Y, determined by reference to the value of all of the Cap shares issued.

In each of the two cases, the ACP initially reported the transaction on the ACP's Federal tax return for 2000 in a manner consistent with the tax analysis set out in the documents and the Form 1099-B received from Cap. E&Y, in completing its Federal Form 1065 partnership return for 2000, similarly took into account all of the Cap stock issued to it in exchange for the interest in CGE&Y that it had sold to Cap.

Cap, as the buyer, took into account the entire value of the shares it tendered (reduced by any shares forfeited by ACP's after the closing of the transaction), in computing its purchase price for the consulting business assets and thus its amortization deductions attributable to the goodwill and other intangible assets acquired.

Cynthia Fletcher and Cathy Culp, two of the ACP's who participated in the sale to Cap, filed amended tax returns in 2003 that recomputed their Federal income tax liabilities for the year 2000. In each case, the amended return indicated that only 25% of the shares allocated to the ACP in respect of the sale had become owned by the ACP in 2000 and were required to be taken into account in that year.

After paying the requested tax refunds, the IRS authorized the Department of Justice to initiate suit against the ACP's on the basis that their refund claims were erroneous. The District Courts for the Middle District of Tennessee, in the *Culp* case, and for the Northern District of Illinois, in the *Fletcher* case, have now granted the Government's motions for summary judgment to compel repayment of the taxes previously refunded.

Discussion

Both courts focused on the intentions and understanding of the parties regarding the tax consequences of the transaction. Specifically, the courts concluded, based on the transactional documents, the explanatory material circulated by Ernst to the ACP's before they executed the final agreements, and the tax returns initially filed by the parties, that all the parties intended that the ACPs be treated for tax purposes as having received in the year of the sale *all* the Cap shares issued to them in exchange for their interests in CGE&Y, and not merely the portion of the shares that were sold in 2000 on their behalf for cash proceeds.

Culp argued that the restrictions on transfer accepted by her, and her agreement to forfeit all or a portion of the Cap shares held in the restricted account if her employment terminated for specified reasons or if she breached certain covenants, established conditions precedent that would have to be satisfied before she could be considered to be the owner of those shares for tax purposes. The court in *Culp* concluded, however, that the terms of the transaction documents and the power of attorney Culp had granted with respect to her shares effectively confirmed that she was already the owner of the shares, because only an owner of outstanding shares could grant or accept such rights or limitations.

The *Culp* decision also notes that the ACP received the benefit of dividends with respect to the Cap shares held in her restricted account, although those dividends were held in the account until the shares were distributed, and that the Culps reported that dividend income on their tax returns for 2001 and 2002. Moreover, the transaction documents included an express understanding as to how the shares issued to the sellers, but not immediately sold, would be valued in reporting the transaction. That provision would not have made sense, at least from the perspective of the ACP's, if the shares were not to be taken into account in the year of sale in determining the gain recognized by each ACP.

Both court decisions discuss the rule initially propounded in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967). Under the *Danielson* rule, as restated by the Court of Appeals for the Sixth Circuit in *Schatten v. United States*, 746 F.2d 319 (1984), a taxpayer "may not challenge the tax consequences of ... [an] agreement absent 'proof which in an action between the parties to the agreement would be admissible to alter the construction or to show its unenforceability because of mistake, undue influence, fraud or duress.'"

The court in *Culp*, being within the Sixth Circuit (one of the Circuits that has adopted the *Danielson* rule), concluded that the rule applied because the parties to the transaction had agreed to report the transaction as a fully taxable sale, with the consideration to be treated as paid and received in the year of sale; and that Culp was seeking to recharacterize the transaction in a manner inconsistent with that agreement. The court found that the *Danielson* rule precluded Culp from unilaterally recharacterizing the transaction as a sale in which only about 25% of the consideration was paid to her in the year of sale, and on that basis paying less tax in the year of sale. The court also found that the taxpayer failed to establish the existence of "mistake" or any other basis for concluding that the *Danielson* rule should not apply.

The taxpayer in *Fletcher* argued that the court could not enforce the provisions of the agreement that at least arguably required her to report for the year of sale the value of all of the Cap shares allocated to her, because it would be a violation of public policy to require her to compute her tax liability in a manner not consistent with provisions of the Internal Revenue Code. In particular, she apparently argued that the shares held in the restricted account were not actually received by her in 2000, and were not "constructively" received in that year either because they were not generally available to her. Since she had neither "actually received" nor "constructively received" the shares held in the restricted account until after the year 2000, she could not be taxed with respect to those shares in that year.[1] The district court did not consider the substance of Fletcher's argument, but, instead, focused on whether the taxpayer would be permitted to make that argument at all.

The court discussed the *Danielson* rule, but noted that it was unclear whether the Seventh Circuit Court of Appeals (to which a decision of that court would be appealable) followed

that rule or, instead, an alternative formulation to the effect that, where the parties to an agreement have agreed upon an allocation of consideration or a characterization of payments for tax purposes, that allocation or characterization will be presumed to be controlling absent "strong proof" that, for example, the allocation or characterization was not what was truly intended. The court in *Fletcher* concluded that it need not resolve which standard was controlling in its circuit, because the Government would prevail under either standard.

In respect of the potential exceptions to the application of the *Danielson* rule in instances where a provision was unenforceable by reason of mistake, undue influence, fraud, or duress, the *Fletcher* court concluded that the taxpayers had failed to raise a genuine issue of fact as to the existence of undue influence or duress. The court also concluded that, in respect of the "strong proof" test, the record contained "no proof, let along strong proof" that the parties intended the ACP's to take the value of the shares of Cap into account in any year other than 2000.

The penultimate paragraph of the *Fletcher* opinion states, "[a]ssuming, *arguendo,* that the parties' agreement to report the Cap Gemini stock as income received by the ACPs in 2000 violates federal tax law, that term would still be enforceable under the circumstances of this case." If the court, by that statement, meant that the parties could, by agreement, override the Federal tax law as to the tax consequences to the parties of the transaction, that statement is almost certainly incorrect. However, given the apparent reasonableness of the original intention, as reflected in the transactional documents, to treat all of the shares allocated to the ACP's as having been transferred to them in the year of the sale, the fact pattern presented a poor context for making the argument that the parties' original intentions as to the tax treatment of the transaction should be disregarded because they were in conflict with controlling provisions of the tax law.

Observations

Neither the Government nor the taxpayers chose to argue that any portion of the shares allocated to the ACP's constituted property transferred to the ACP's in consideration of services to be rendered by them, rather than in exchange for the interests in the consulting business that they transferred. Had stock of Cap been considered to have been received by an ACP in consideration for services, then the requirement that the stock held in each restricted account be forfeited upon a voluntary termination of employment might have constituted a "substantial risk of forfeiture" that, under the rules governing compensation income, could have prevented the stock from being included in the income until the risk of forfeiture lapsed. Such an argument would also, however, have undercut the taxpayers' positions that receipt of the shares resulted in capital gain, rather than ordinary income.

Taxpayers other than those involved in these cases (and other than ACP's of E&Y who have taken similar positions) may also find a silver lining in these opinions, in the form of confirmation of the courts' inclination to honor the expressed intentions of parties to a transaction as to the tax consequences of the transaction, where those intentions are clearly reflected in the parties' agreement and reconcilable with the relevant tax rules. Of course, such an agreement will not preclude the IRS from challenging the agreed-upon treatment as to any or all of the parties.

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[1] The taxpayer's argument sidestepped the point that, in the context of a sale or exchange, an obligation to pay money or other property in the future must generally be taken into account when received in determining the gain realized upon the transaction, unless the installment method applies -- which was apparently not the case here. *See* Treas. Reg. §§1.1001-1(a), 15a.453-1(e).

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