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Can Capital Gain Rates Apply to Income from Phantom Stock?

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For the time being, and unless and until Congress enacts significant changes to the Internal Revenue Code (the "Code"), the distinction between ordinary income and capital gain is a fundamental one. Taxpayers and their advisors are always on the lookout for opportunities to put income into the capital gain pigeonhole, where it is generally taxed at favorable rates, and over the years the courts and the Internal Revenue Service developed a variety of doctrines to prevent the capital gain exception from swallowing the ordinary income general rule.

Section 1234A of the Code represents Congress's reaction to what it viewed as an overly strict application of one of those doctrines, specifically the conclusion that, because the statutory rules governing capital gain require a "sale or exchange," capital gain treatment was unavailable in a transaction in which the taxpayer received consideration for extinguishing a right that the taxpayer held, as distinguished from transferring that right to a third party. The scope of section 1234A was considered in a recent order of the Tax Court in *Hurford Investments No. 2, Ltd. v. Commissioner* (Dkt. 23017-11, April 17, 2017), in which the principal issues were the tax basis of a partnership (HI-2) in so-called "phantom stock" issued by a corporation, and whether gain from the receipt of payment in respect of the phantom stock was capital gain under section 1234A.

Background

Gary Hurford received phantom stock from his employer, the Hunt Oil Company, in connection with his employment. The phantom stock was a right to deferred compensation required to be "redeemed," for an amount per phantom share approximating the value of an actual share of Hunt Oil common stock, on the fifth anniversary of a qualified termination of service.

The redemption would occur in the form of a credit to an interest-bearing phantom account on the books of the company. The account value could also fluctuate depending on the company's value. If the stockholder equity increased, the account value would increase by the lesser of the percentage increase in the stockholder equity or the 90-day Treasury rate. If the stockholder equity declined, the value of the account would be reduced by an equal percentage. The account could be converted to cash at any time by the account holder or Hunt Oil.

Gary's death in 1999 was a qualified termination of service for purposes of the phantom stock that was inherited by his surviving spouse, Thelma Hurford. She transferred the phantom stock in 2000 to HI-2 as a part of a plan involving three family limited partnerships (including HI-2). In earlier proceedings (*Estate of Hurford v. Commissioner*, TC Memo 2008-278), the Tax Court determined those transfers to have been motivated solely by an intention to reduce estate taxes, and to have been ineffective for that purpose. Accordingly, the value of the phantom stock at the time of Thelma's death in 2001 ($9.6 million) was included in her taxable estate.

The phantom stock was redeemed by Hunt Oil in 2004, with a credit being made to a phantom account. That account was liquidated by the company in 2006, with a payment being made to HI-2 of almost $13 million.

Discussion

In general, under Code section 1014(a) the basis of property included in a decedent's estate is its fair market value at the time of death. That general rule does not apply with respect to property constituting a right to receive an item of "income in respect of a decedent" ("IRD") under Code section 691(a). Given the nature of phantom stock as a contractual right to deferred compensation, the exception for IRD items would normally have applied to Gary's phantom stock, and there would have been no basis step-up in the phantom stock by reason of his death.

Different rules under section 691(a)(2) apply, however, when an IRD item is transferred. Because the phantom stock had been transferred by Thelma to HI-2 in 2000, the value of the phantom

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stock at the time of that transfer ($6,400,000) was required to be included in her income as IRD. In fact, the IRS entered into a closing agreement with HI-2 in 2011 confirming that this value was IRD under section 691, and that the initial basis of HI-2 in the phantom stock was the IRD amount.

The government's first argument, in its motion for summary judgment that the phantom stock liquidation resulted in ordinary income (consistent with HI-2's original reporting on its 2006 Form 1065), was that HI-2 was not a valid partnership for tax purposes and that Thelma continued to own the phantom stock (as an IRD item, presumably) until the time of her death. The court viewed the existence of the closing agreement with HI-2 and its conclusion in respect of IRD at the time of transfer to HI-2 as undermining this argument. (In fact, Thelma never included the value of the phantom stock in her income as ordinary income, and the partnership reported that value as short-term capital gain under a rationale not apparent to the court; but the court found these circumstances irrelevant to the motions before it.)

Tax basis for phantom stock: The Tax Court further concluded that the phantom stock, once transferred to HI-2, was no longer subject to section 691. Therefore, the basis of the phantom stock was increased to fair market value upon the death of Thelma by reason of the inclusion of the phantom stock in her estate for estate tax purposes.

Character of gain: The Tax Court considered (i) whether the phantom stock held by HI-2 was a capital asset and (ii) whether there had been a "sale or exchange" of a capital asset as required to result in capital gain under Code section 1222.

The phantom stock had been transferred by Thelma to HI-2 (albeit in a contribution to a partnership by a partner for no apparent stated consideration, rather than an arm's length transfer), and an IRD amount was determined by reason of that transfer. From these facts, the court determined that the phantom stock as owned by HI-2 was not a right to ordinary income, but rather "property" within the scope of the definition of a "capital asset" in Code section 1221.

In an analogous context, regulations under Code section 83 provide that a transfer of a compensatory stock option to a related entity does not prevent the application of section 83—and, thus, the realization of ordinary income in the nature of compensation—upon a later exercise of the option (Reg. section 1.83-7(a); see also Reg. section 1.83-1(c)). However, this analogy, which would support the position of the Commissioner, was not discussed in the court's order; further, the ability of the Commissioner to argue by analogy to these regulations may have been constrained by the closing agreement that determined an IRD amount as of the date of transfer to HI-2.

The government did argue that, even if the phantom stock was a capital asset, the liquidation of the phantom stock account could not result in capital gain under Code section 1222 because that liquidation was a disposition other than a "sale or exchange" (as generally required to achieve capital gain treatment).

HI-2 argued that the gain from the liquidation could be treated as gain from the sale of a capital asset under section 1234A, which provides in part that "[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of—(1) a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer" will be treated as capital gain.

The Tax Court previously gave a broad meaning to the quoted words in *Pilgrim's Pride Corp. v. Commissioner*, in which it determined that an abandonment of stock, effected by surrender of the stock to the issuer for no consideration, was a lapse or termination of rights with respect to the stock within the scope of section 1234A. The Court of Appeals for the Fifth Circuit reversed, reasoning that section 1234A applied to the termination of rights or obligations to buy or sell capital assets, but not to the termination of the ownership of a capital asset (779 F.3d 311 (5th Cir. 2015), reversing 141 T.C. 533 (2013)).

In *Hurford*, the Tax Court reasoned that the phantom stock and the resulting phantom account gave HI-2 the right to select the time at which the phantom stock would be sold, until Hunt Oil terminated that right by liquidating the account. Hunt Oil, in liquidating the account, terminated HI-2's right to sell the phantom stock at a time of its choosing, rather than a termination of ownership of property as in *Pilgrim's Pride*. The Tax Court therefore concluded that section 1234A applied.

Observations

The opinion does not discuss the possibility that the phantom stock was a "right or obligation" with respect to the common stock of Hunt Oil until 2004, but that HI-2's rights to the proceeds ceased to have that character once the phantom stock was redeemed.

The phantom stock described in *Hurford* would, if issued today, raise issues under the "nonqualified deferred compensation" rules of Code section 409A (as well as under tax doctrines predating section 409A, such as the doctrine of constructive receipt). Therefore, it may be unlikely that an essentially identical fact pattern will be addressed by other courts. More broadly, however, *Hurford* underscores the continued potential for confusion as to the consequences of transfers of compensatory rights in non-arm's length transactions, and continued uncertainty regarding the scope of section 1234A.

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