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# Shareholder Dispute Gives Rise to Tax Disputes

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The circumstances are not always amicable when the interest of one owner of an S corporation is to be bought out by the other owner or owners or by the entity itself.[1] There may be disputes as to the amount to be paid to the selling owner or when it will be paid. As the parties work through those disputes, through negotiation (before or after a formal "closing"), arbitration, and litigation, an issue that often gets short shrift is the time at which the buyout is considered to be effective for tax purposes.

Sellers may face an unpleasant surprise when the Internal Revenue Service challenges their reporting of the transaction, contending either that the sale occurred at a later time than they thought -- thereby requiring the selling shareholder to continue including a share of the corporation's income on the seller's tax return -- or at an earlier time -- thereby accelerating the date on which the seller's gain on the sale must be reported. Similar issues can affect buyers, who may be chagrined at the date on which they begin to be required to report the seller's former share of the income of the corporation (or, if the corporation is incurring tax losses, the date on which they are permitted to begin reporting the seller's former share of those losses).

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If the parties take inconsistent positions regarding the reporting of the corporation's income -- with each trying to report only a portion of the income for the period prior to full resolution of their disputes -- the situation is particularly likely to attracted unwanted attention from the Service. Two recent cases, one a Tax Court decision and the other a decision of the Court of Appeals for the Ninth Circuit, affirming the Tax Court, illustrate how disputes between shareholders relating to the timing and amount of a buyout can give rise to inconsistent positions as to the effective date of a shareholder buyout and related income allocation issues and ultimately to controversies with the tax authorities.

### *'Dunne v. Commissioner'*

In *Dunne v. Commissioner,*[2] FRC International, Inc. (FRC) was formed by Joseph Dunne (Dunne) in 1982 to sell halon and other fire protection material. In 1993, Richard Marcus (Marcus) became a 50% shareholder of FRC, with Dunne retaining his shares.

In 1995, the two shareholders began to disagree about the operation of the business, and to discuss possible buyout arrangements. On August 1, 1996, they agreed informally that Dunne would sell his stock to Marcus by the end of 1996, for a price to be based on an independent valuation of FRC. However, no contract of sale was entered into at that time, and the stock was not sold in 1996.

In January, 1997, Marcus made an offer to buy out Dunne based on the informal agreement, but the offer was not accepted. Later in the same month, Marcus terminated Dunne's employment by FRC, and Dunne was not involved thereafter in the management or operation of the business. In February, 1997, Dunne filed a petition for the appointment of a custodian for the corporation.

About three months later, Dunne and Marcus entered into a settlement agreement dated May 8, 1997, under which it was agreed that Dunne would receive, in exchange for his stock, $175,000 plus 50% of the profits from a particular contract to sell halon.

Under the settlement agreement: Dunne's stock was to be delivered in escrow on the settlement date; the $175,000 amount would be paid on the settlement date, or in monthly installments commencing June 1, 1997; the settlement date would be the date of signature of a "memorializing document"; the memorializing document was to be completed no later than May 16, 1997; Dunne would have "no shareholder or director rights" after the settlement date; and any disputes were to be resolved by arbitration. The settlement agreement as quoted in the Tax Court opinion does not refer to any condition to closing apart from delivery of Dunne's shares to escrow.

No settlement occurred by May 16, 1997, and the parties ultimately went to arbitration. The arbitrator entered an award on June 8, 1998, which fixed the payment to be made to Dunne attributable to the halon contract at approximately $511,000. The award also provided for his stock certificates to be deposited in escrow and for a settlement date of June 22, 1998.

The parties did not comply with the arbitration award and instead went to court, with Marcus and the corporation seeking confirmation of the award. A U.S. District Court upheld the arbitration award, and all parties involved appealed that determination.

On October 30, 2000, Dunne, Marcus, and FRC entered into an agreement and release to resolve all disputes between them. Pursuant to that agreement, Dunne endorsed and delivered his stock certificates to Marcus, and Dunne and FRC paid to Marcus the balance of what was due under the arbitration award.

FRC was an S corporation and included with its returns for 1997 and 1998 Schedules K-1 that treated Dunne as a shareholder until June 22, 1998 (the settlement date specified in the arbitration award). On that basis FRC allocated a substantial amount of income to Dunne for 1997. (FRC incurred a loss during 1998.) The Dunnes, on their joint tax return for 1997, did not include in their income any portion of the income items shown on the K-1 issued to them by FRC for 1997.

The IRS audited the Dunnes' tax returns for 1997 through 1999. Concluding that Dunne remained a shareholder of FRC until June 22, 1998, the settlement date determined by the arbitration award, the IRS asserted a tax deficiency for 1997 on that basis.

After a lengthy discussion, the Tax Court concluded that Dunne remained a beneficial owner of (as well a holder of legal title to) FRC shares until the execution of the settlement agreement on May 8, 1997. The court quickly dismissed the argument by Dunne that the informal agreement of the shareholders in 1996, which was never memorialized in a written agreement and did not bind the parties to a specific price or date of settlement, conveyed ownership of Dunne's shares.

However, the court further concluded that Dunne ceased to be the beneficial owner of the shares on May 8, 1997, upon the execution of the settlement agreement, notwithstanding that legal title to the shares was not transferred until years later. The court cited the circumstances that: the price was determined at that point, pursuant to a settlement agreement that had been determined to be valid and legally enforceable; that the agreement called for a closing within about a week after the agreement was signed; and that the consideration to be paid to Dunne for his shares would not be affected by the business successes and failures of FRC (apart from profits under one contract) after the settlement date.

### *'Hightower v. Commissioner'*

*Hightower v. Commissioner*[3] involved a corporation organized by three individuals in 1986 as Green Hills Software, Inc. (Green Hills). Two of the shareholders, Glenn Hightower (Hightower) and Daniel O'Dowd (O'Dowd), bought the stock of the third shareholder in 1992. At that time, Hightower and O'Dowd entered into a shareholders' agreement that provided that any disputes between them would be resolved by binding arbitration, and that either shareholder could compel a buyout of the other shareholder's stock at a price determined by formula.

The relationship between the two shareholders deteriorated in 1997 and 1998. In March, 1998, O'Dowd demanded that Hightower leave the premises of Green Hills, and O'Dowd then terminated Hightower's employment by the corporation.

By letter dated June 26, 1998, O'Dowd triggered the buy/sell provision of the shareholders' agreement by offering to either sell his shares to Hightower, or to buy Hightower's shares for $47 million. The letter also stated that O'Dowd had deposited a certified check payable to Hightower for $47 million with Green Hills, in accordance with the shareholders' agreement.

Hightower did not want to sell his shares and instead sought to buy the shares of O'Dowd, but could not obtain financing.

In August, 1998, Hightower demanded arbitration regarding the buyout. The arbitrator issued a "proposed interim award" in December 1999, and a "partial final award" in March 2000 which permitted O'Dowd to treat the purchase of Hightower's stock as having occurred on September 24, 1998, 90 days after O'Dowd invoked the buyout provisions of the agreement. The arbitrator concluded that O'Dowd's actions were consistent with the buyout provisions of the shareholders' agreement, and that O'Dowd had the right (but not the obligation) to pay or to cause Green Hills to pay Hightower the $47 million price for the shares by September 24, 1998.

The arbitrator further found that the purchase price would be reduced by dividends and salary (net after payment of taxes) paid to Hightower for periods after September 24, 1998. To the extent the buyout was further delayed, Hightower would be entitled to dividends on his shares, but those dividends would be credited against the purchase price ultimately to be paid for the shares.

After engagement of an accountant to determined the adjusted purchase price in light of the arbitration award, checks in payment for the shares were delivered by O'Dowd to Hightower on October 13, 2000. Hightower deposited the checks in an interest-bearing account opened in his name for the purpose of holding these funds.

Hightower sought to have the arbitration award stayed or vacated through proceedings in state court, but was unsuccessful. The arbitrator issued a final award on August 29, 2001, confirming that the sale of the stock was effective on October 13, 2000, and that Hightower's interest in the corporation terminated on that date.

Hightower was treated by Green Hills on its tax returns as a shareholder through October 13, 2000. The personal tax returns filed by Hightower for 2000 and 2001, however, did not include any of: his distributive share of Green Hills' income for 2000; the payment of approximately $42 million ultimately made for his shares; or the interest credited to the account holding those funds.

Before the Tax Court, Hightower contended that, under the "claim of right" doctrine, the amount that he received for the stock was not taxable to him in 2000 or 2001. More specifically, he argued that he was not required to include the funds in income because he opposed the stock buyout, established a separate account to hold the funds, and did not use the funds during those years.

The Tax Court concluded that the claim of right doctrine did not apply, however, because the account in which the funds were held was not a trust account or otherwise restricted, and because Hightower had no fixed obligation to O'Dowd or anyone else to relinquish the funds, notwithstanding his efforts to overturn the arbitration award. The court further noted that Hightower's acceptance of the checks was voluntary (in that he could have refrained from depositing the checks) and that he had no obligation and no intention of returning the funds to O'Dowd or anyone else absent a determination by a court to vacate the arbitration award.

The Tax Court also addressed whether Hightower was required to include in his income the distributive share of the income of Green Hills that was allocated to him on the corporate return and Schedule K-1 for the period of his stock ownership that ended October 13, 2000. he court concluded that this income was included in Hightower's taxable income because he remained the beneficial owner of the shares until that date, reasoning that the arguments made by Hightower based on his having had, after 1998, a reduced role in the corporation and a poor relationship with the other shareholder were irrelevant to the question of whether he remained the beneficial owner of the shares.

In resolving this issue against Hightower, the court also noted that the arbitrator had taken into account, in determining the payment to be made to Hightower for his shares, that Hightower would be subject to the higher rate of tax applicable to ordinary income with respect to his distributive share of the corporation's operating income by reason of continued ownership of shares until October 2000, as compared to the lower (capital gains) rates that would generally have applied if the same amount of income had been recognized as capital gain, and had increased the payment to be made to Hightower to take that into account.[4] The court concluded that Hightower would receive a windfall if he was allowed to retain the extra funds that were paid to him through the arbitration award to cover a portion of his tax liability with respect to the distributive share of income.

The Court of Appeals for the Ninth Circuit, by memorandum, affirmed the decision of the Tax Court. With respect to the issue concerning the distributive share of income allocated to Hightower for 2000, the Court of Appeals observed that: "Contrary to Hightower's assertion, the arbitration award did not have the effect of divesting him of beneficial ownership of his Green Hills shares in 1998. Rather, it merely gave O'Dowd the financial benefit of the bargain retroactively once the sale took place in 2000."

It is noteworthy that, in *Hightower*, the taxpayer was treated as the beneficial owner of shares until 2000, notwithstanding that he had, effectively, no participation in the benefits of ownership of the shares in that year beyond the fixed price effectively determined by the buyout offer made in 1998. If, by some date in 1998, O'Dowd had the obligation as well as the right to pay for those shares and also had effective ownership and control over Green Hill and those shares, it is at least arguable that, under the reasoning expressed in *Dunne* and other case law dealing with the time-of-sale issue, Hightower should not have been viewed as a shareholder after 1998 for tax purposes.

While a number of lessons could be drawn from these cases, perhaps the most salient point is that tax considerations, including the effective date of the sale for allocation purposes and the manner of allocation of income for the final period, should be addressed at the time settlement negotiations are underway and resolved in the settlement agreement if at all possible. If that is done and the parties file their tax returns on a basis consistent with the agreement, it is far less likely that there will be post-closing controversies with the tax authorities regarding such matters.

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1 Similar issues may arise with respect to buy-outs involving partnerships or limited liability companies classified as partnerships for tax purposes.

2 TC Memo 2008-63, March 12, 2008.

3 101 AFTR 2d 2008-836 (9th Cir., Feb. 12, 2008), affirming TC Memo 2005-274 (Nov. 28, 2005).

4 Because the allocation of a distributive share of corporate income to Hightower would increase his basis for the shares, the effect of the allocation would not be to increase his overall income attributable to the ownership and disposition of the shares but rather to change the rate at (and, possibly, the taxable year in) which it would be taxed.

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