December 19, 2013

"Fish": Ordinary Income From Incorporation Transaction

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Under Section 351 of the Internal Revenue Code, a business may be transferred to a corporation in exchange for its stock without the recognition of income or gain, so long as the transferors are "in control" of the corporation (under an 80% ownership standard) immediately after the transfer and certain other requirements are met. Conversely, if an appreciated business is sold to an unrelated person, the sale will generally result in income treated as capital gain, except to the extent attributable to such assets as inventory, receivables, or "recapture" with respect to depreciable property.

Starting from these rules of thumb, it may come as a surprise that the transfer of a business to a corporation for a combination of stock and cash (purportedly qualifying for nonrecognition treatment under section 351, except to the extent of the cash received) may lead to a worse result in terms of character of income—more specifically, to ordinary income rather than capital gain—than would a sale of the same assets to an unrelated third party. A recent Tax Court memorandum decision, *Fish v. Commissioner*,[1] illustrates how this might occur.

Facts in Fish

FishNet Consulting, Inc. (Consulting), an S corporation of which Gary Fish (Fish) was the sole shareholder, was incorporated in 1998 to conduct a growing network security business. In September 2004, after Consulting had retained a financial adviser to evaluate potential financial partners and a possible sale of the company, a private equity fund offered to purchase newly created convertible preferred stock in Consulting, to represent 43% of the company's equity on a fully diluted basis, for $12 million. This amount was to be distributed to Fish in partial redemption of his shares.

Because a corporation, in order to maintain its tax status as an S corporation, is required to have only one class of stock,[2] the issuance of preferred stock would have prevented Consulting from continuing to qualify for this favorable tax status. For this and (no doubt) other reasons, a more complicated transaction was implemented.

First, in November 2004, Fish incorporated Fish Holdings, Inc. (Holdings), for which an S corporation election was made. Fish then contributed the stock of Consulting to Holdings, and Holdings made a "QSSS election" to treat Consulting as a "qualified subchapter S subsidiary" under IRC section 1361(b)(3)(B). As a result of that election, Consulting would be considered, for federal tax purposes, to be liquidated into Holdings in a nontaxable liquidation (even though Consulting retained its separate corporate existence for state law purposes) and thereafter to be disregarded as a separate entity for federal tax purposes.[3] This sequence of steps was treated for tax purposes as a tax-free reorganization in the nature of a reincorporation.

Consulting, Fish, and several investor partnerships entered into a stock purchase agreement, under which the partnerships purchased convertible preferred stock of Consulting for $10.5 million on January 3, 2005, and agreed to purchase an additional $1.5 million of preferred stock within three years thereafter. The sale proceeds from the initial sale of preferred stock were paid to Fish as the owner of Holdings, the sole common stockholder of Consulting, and Consulting was renamed FishNet Security (Security).

The issuance of the preferred stock caused Security to cease to qualify as a QSSS. Security was therefore treated for tax purposes as a new corporation acquiring assets (and assuming liabilities) immediately before such cessation from Holdings, in exchange for Security stock.[4] This transaction was considered to have occurred immediately before the preferred stock was issued and just two months after Security (formerly Consulting) was considered to have made a "liquidating distribution" of the same assets, subject to the same liabilities, to Holdings.[5]

Security's tax return for 2005 showed intangible assets with an amortizable basis of $9,462,700 at the beginning of the year, and claimed an amortization deduction of $630,847 for 2005, consistent with the 15-year amortization

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period generally applicable to amortizable intangibles under IRC section 197. Although the tax return did not specify what intangible assets had been acquired by Security, a footnote in the opinion indicates that the court understood the intangibles to consist primarily of goodwill that had which received a basis step-up by reason of the "transfer" that was considered for tax purposes to have been made from Holdings to Security and the associated "receipt" by Holdings of cash (ultimately paid to Fish) that gave rise to recognition of gain.

Holdings's tax return for 2005 reported $9,687,699 of distributions from Security, consisting of $9,463,227 received on the date of closing in January 2005 and an additional distribution in December 2005 made as an adjustment under the stock purchase agreement. Substantially all of those distributions were treated as long-term capital gain and passed through by Holdings to its shareholder, Fish.

The IRS issued a notice of deficiency to Fish determining that additional tax was due on the ground that the amount reported by Holdings as long-term capital gain should have been characterized as ordinary income (i) under IRC section 1239 (discussed below) and (ii) to a much lesser extent under IRC section 1245 (relating to depreciation recapture). Fish conceded that $175,570 of gain should have been reported as ordinary income under section 1245, and the only issue before the Tax Court was whether the balance of the capital gain should instead have been treated as ordinary income under section 1239.

Discussion

Where property is sold or exchanged between certain related persons and the property is, in the hands of the transferee, of a character subject to depreciation for tax purposes (including amortization under section 197), any gain recognized to the transferor must be treated as ordinary income under section 1239. The purpose of section 1239 is to prevent a taxpayer's sale of low-basis depreciable property from giving rise to long-term capital gain, taxed at preferential rates, while the related purchaser is computing its depreciation deductions, that may be offset against ordinary income, on a stepped-up basis. One relationship covered by section 1239 is that between two corporations more than 50% of the stock of one of which, as determined by voting power or by value, is owned by the other.

There was no dispute that there had been a sale or exchange upon which gain was required to be recognized. The court characterized the cash received by Fish under the stock purchase agreement as money, often referred to as "boot," originally received by Holdings in a deemed exchange of assets for Security stock, resulting from the termination of the QSSS election, in a transaction governed by IRC section 351. Section 351(b) provides that, where such boot is received, gain must be recognized to the transferor (in this case, Holdings), but not in excess of the amount of cash received.

Where several assets are transferred to a corporation in a section 351 transaction with boot, each asset is considered to be transferred separately in exchange for a portion of each category of consideration received (which is in turn allocated based on the relative fair market values of the assets transferred), such that the amount and character of gain is determined on an asset-by-asset basis.[6] If the transferor and the transferee are related persons under section 1239 standards, gain recognized under section 351(b) with respect to depreciable property is treated as ordinary income.

These rules are quite well established, and Fish did not challenge their existence, but he did argue that section 1239 did not apply for other reasons. The bulk of the opinion discusses whether or not Holdings and Security were related persons under either the voting power or value standard. With respect to voting power, Fish argued that Holdings should not be viewed as having more than 50% of the voting power of Security—even though each share of common stock and preferred stock was entitled to one vote, Holdings owned approximately 14 million shares of common stock, and the investors owned only approximately 8.5 million shares of preferred stock—because, of the five directors of Security, two were to be elected by the common shareholder, two by the preferred stockholders, and the fifth director was also to be elected by the common shareholder but was required to be "independent" and to be approved by the preferred stockholders. Such approval was not to be unreasonably withheld. Also, certain fundamental corporate changes required the consent of both Holdings and a majority of the holders of the preferred stock.

Case law on the determination of corporate voting power for various tax purposes (and discussed in the opinion) provided support for Fish's position that voting power is not determined solely by reference to the number of votes associated with shares owned by each shareholder, but also by reference to the power to elect directors and to approve or disapprove of fundamental changes in corporate structure. However, the court found that the right of Holdings to elect three out of five directors of Security, albeit (with respect to one director) subject to the approval of the preferred stockholders (such approval not to be unreasonably withheld), caused Holdings to have more than 50% of the voting power.

The court also found that, even if Holdings had not had more than 50% of Security's voting power, it was still a related person to Security for purposes of section 1239 under the stock value test. The report of a valuation expert engaged by Fish concluded that, if Security had been liquidated immediately after the closing of the stock purchase, the amount received by the preferred stockholders as a liquidation preference, coupled with their rights to participate in the remaining proceeds of the liquidation after the liquidation preference was satisfied, would provide them with a total amount in excess of what would have been received by the common stockholder. Fish argued that, accordingly, Holdings owned less than 50% by value of the stock of Security.

By contrast, the government's valuation expert assumed that that the business would be continued by Security for several years and that the preferred stock should be valued by reference to a redemption right that would first become exercisable (by holders of the majority of the preferred shares) four years after the closing of the stock purchase. That redemption right provided for the preferred shareholders to receive the greater of the amount paid by the investors for their shares (plus accrued but unpaid dividends) or the shares' then fair market value, as apparently to be determined as a percentage of the total fair market value of Security.

The court characterized the hypothetical liquidation approach of the taxpayer's expert as "misdirected" in the context of the circumstances of the stock purchase, found the government's valuation approach more persuasive, and concluded that Holdings owned more than 50% of the value of the stock of Security. Thus, under either the voting power test or the value test, Holdings and Security were found to be related for section 1239 purposes, and the gain recognized on the deemed sale of intangible assets was ordinary income.

Observations

It seems at least arguable that the characterization in the opinion of the cash received by Holdings as boot in an otherwise nontaxable section 351 transaction was incorrect. IRC section 1361(b)(3)(C) as in effect during the year at issue characterized the termination of QSSS status as resulting in an acquisition by the QSSS of its assets in exchange for stock, but did not further characterize that acquisition as a transfer within the scope of section 351; and an example in the regulations under section 1361 indicated that section 351 would *not* apply to the deemed transfer of assets where the termination of QSSS status was the result of a sale of more than 20% of the stock of the QSSS to an unrelated corporation for cash, because that sale would cause the S corporation not to meet the 80% control requirement for a section 351 transaction with respect to the QSSS after the transfer.[7]

If the characterization described in the example in the regulations were to be applied to the circumstances in *Fish*, the exchange of stock for assets would have been taxable in full, rather than only to the extent of the boot received. Given that the exchange between Holdings and Security would be considered to occur as of immediately before the cessation of Security's QSSS status, the parties to the exchange would be related within the meaning of section 1239.

On the other hand, it seems likely that gain from the transaction described in *Fish* would not be subject to section 1239 today in light of an amendment to section 1361 subsequent to the year at issue.[8] Under the statutory amendment, where QSSS status is terminated by a sale of stock of a QSSS, the stock sale is treated as a sale of an undivided interest in the assets of the QSSS followed by a contribution of assets in exchange for stock in a transaction to which section 351 applies. Because the deemed sale of an undivided interest in the assets would likely be made to an unrelated person, section 1239 might not apply with respect to a post-2006 transaction similar to the stock purchase described in *Fish*.

However, the court's methodology in computing voting power and value continues to be relevant in the context of applying section 1239 to actual transfers of property between corporations, as well as by analogy under other provisions of the tax law, and section 1239 remains a potential trap for the unwary in the context of any transfer of depreciable property between related parties where gain is required to be recognized.

1 TC Memo 2013-270.

2 IRC § 1361(b)(1)(D).

3 See IRC § 1361(b)(3)(A).

4 See IRC § 1361(b)(3)(C).

5 So far as is indicated in the opinion, the government did not raise and the Tax Court did not consider whether the liquidation and reincorporation reported for tax purposes as resulting from the QSSS election and later cessation of QSSS status should have been disregarded or otherwise recharacterized in light of the proximity in time and the likelihood that they were undertaken pursuant to a single plan.

6 Rev. Rul. 68-55, 1968-1 C.B. 140.

7 Treas. Reg. § 1.1361-5(b)(3), Example 1.

8 Section 1361(b)(3)(C) was amended by the Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28, §8234(a)), effective for taxable years beginning after 2006, to overturn the result indicated by the regulation discussed above.