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FCG VALUATION CASE E-FLASH

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Jess L. Miller, Petitioner v. Commissioner of Internal Revenue, Respondent
Docket No. 26567-08, T.C. Memo 2011-189, Judge: Hon. Mary Ann Cohen, August 9, 2011

Taxpayer gifted shares of privately held JAM Pharmaceutical, Inc., ("JAM" or the "Company") to his son. He also executed a purchase agreement with son to purchase a 95% interest in the Company. However, Taxpayer failed to comply with the terms of the purchase agreement, received distributions in excess of his basis in the stock, and faced a significant long-term capital gain tax liability as a result.

TAKEAWAY

Interestingly, the court indicated "the parties do no argue that disproportionate distributions from JAM created a second class of stock for purposes of section 1361(b)," which is prohibited in an S corporation such as JAM. Even so, the Taxpayer argued that an example presented in IRC § 1.1361-1(1)(2)(vi) provided evidence that his disproportionate distribution was exempt from taxation. However, the IRC example had facts substantially different from the case at hand and the Taxpayer provided no evidence that "corrective distributions" (as shown in the example) were made by JAM. Hence, the court disallowed the Taxpayer's argument.

THE FACTS

Jess L. Miller ("Mr. Miller" or the "Taxpayer") acquired – through a revocable trust – all 10,000 shares of JAM. During 2002, Taxpayer, as sole shareholder and director of JAM, amended the Company's articles of incorporation to permit two classes of common stock: 1 million shares of Class A voting stock and 1 million shares of Class B nonvoting stock. The Taxpayer surrendered his 10,000 shares in exchange for two, 5,000 share blocks (10,000 shares total) of Class A stock and 90,000 shares of Class B stock.

In December 2002, Taxpayer as seller executed a purchase agreement ("Agreement") with his son, as buyer. The Agreement indicated that there were 1,000,000 shares of stock and that amount represented all of the shares issued and authorized to be issued. The Agreement required the seller to resign as director and officer on the closing date and all of the shares of JAM would be sold to buyer. "Seller shall sell to Buyer 950,000 shares of the Company for a purchase price of per share of $.10." The closing date was not specified in the Agreement, buyer never paid $95,000 to seller, and Taxpayer did not resign as an officer/director of JAM.

As of December 31, 2002, Taxpayer's adjusted basis in JAM stock was $866,795 (his original basis plus the value of JAM's accumulated adjustment account).

During 2003, Mr. Miller filed a gift tax return Form 709 for 2002. On the return, Taxpayer indicated that 5,000 shares of Class A stock and 90,000 shares of Class B stock were transferred and Mr. Miller's bases in the stock were $43,340 and $780,116, respectively. A business valuation report with an August 31, 2002, effective date determined the fair market values of the Class A and Class B stock were $34,600 and $511,200, respectively.

Also during 2003, JAM distributed $619,551 to Taxpayer. During 2004, JAM filed its 2003 1120S and attributed 5% of the Company's income to Mr. Miller. The next year, JAM filed an amended 2003 1120S and again indicated Taxpayer owned a 5% interest in the Company.

In 2006, the IRS examined the amended 1120S and made significant adjustments to it, including determining $548,664 in distributions were made to Taxpayer in excess of his basis. The next year, Taxpayer's son, as majority shareholder of JAM, accepted the IRS adjustments to the Company's 1120S.

During 2007, Taxpayer filed a Form 709 for 2003. None of the gifts shown on Form 709 were for gifts of JAM stock.

The IRS sent Mr. Miller a notice of deficiency for 2003. In the 2008 notice, the IRS determined the Taxpayer's basis in JAM stock was $51,661 after his 2002 gift of the Company's stock. As a result of the transfer and reduced basis, the 2003 distributions were $548,664 in excess of his basis in the stock. The distributions were taxable as long-term capital gains and the Taxpayer had a tax deficiency $176,164.

Mr. Miller challenged the IRS determination of his 2003 basis and the resulting tax deficiency associated with the 2003 distributions.

DISCUSSION
According to IRC § 1368(b), distributions in excess of a shareholder's basis from S corporations without accumulated earnings and profits are treated as a gain from the sale or exchange of property.

Respondent determined Taxpayer's 2002 basis by subtracting his basis shown on the 2002 Form 709, $823,456, from his previously determined $866,795 basis in JAM stock. For reasons not shown, IRS calculated this difference as $51,661, rather than $43,339. Because the IRS did not argue for a figure other than $51,661, that figure was used throughout the Court's determination. The IRS then added his 2002 basis to his $19,123 from 2003 JAM taxable income and $103 in 2003 interest income to determine his 2003 basis as $70,887.

Because 2003 distributions to Taxpayer were $619,551, the Respondent determined that Taxpayer had $548,664 in distributions in excess of his $70,887 basis. Respondent further contended that the excess distributions were taxable under § 1368(b) as long-term capital gains.

Taxpayer argued first that Respondent's determination was incorrect because his gift was not made as of December 31, 2002. Taxpayer contended that the date of transfer was some unspecified date after December 31, 2002. The Tax Court gave no credence to that argument because the Taxpayer filed and signed a Form 709 for 2002, and he never filed to amend the 709. Further, stock certificate stubs also indicated the date of transfer was December 31, 2002. Finally, the Court noted that the Taxpayer filed a Form 709 for 2003 but did not report a gift of JAM stock on that return. As a result of the preceding, the Tax Court determined the date of transfer was December 31, 2002.

Mr. Miller also argued that the Agreement indicated a sale had taken place, and the $95,000 purchase price must be counted against distributions paid to him during 2003. The Tax Court noted the existence of the Agreement but then determined that Taxpayer's and son's failure to follow the requirements of the Agreement indicated no sale had taken place.

In particular, the Court found the following factors most persuasive in determining no sale had taken place:
- The Agreement's stipulated number of shares does not match the 2002 amended articles authorizing 1 million Class A and 1 million Class B shares,
- The Taxpayer only owned 100,000 total shares and couldn't possibly transfer 1,000,000 shares as required by the Agreement,
- The Taxpayer failed to resign as officer/director of JAM as required in the Agreement, and
- The Taxpayer failed to report a sale of JAM stock on either his 2002 or 2003 tax returns.

Because no sale had taken place and because the Court determined Mr. Miller had transferred a 95% interest on December 31, 2002, the Tax Court sustained the Respondent's arguments. Accordingly, Taxpayer received $548,664 of distributions in excess of his 2003 basis, the excess distributions were to be taxed as long-term capital gains, and Mr. Miller's tax liability was $176,164.

CONCLUSION

The Taxpayer's failure to follow the steps outlined in his purchase agreement doomed his argument that he had sold stock to his son. Additionally, discovery after the fact of adverse tax consequences does not allow taxpayers to avoid liabilities. Proper estate and tax planning could have allowed the Taxpayer to avoid the problem

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