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## Decisions Tackle Corporate Equity and Compensation

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Two decisions issued in July, one by the Court of Federal Claims (*Greiner v. United States*)<sup>1</sup> and the other by the Tax Court (*Qinetiq U.S. Holdings, Inc. v. Commissioner*),<sup>2</sup> address situations where, in the context of a sale or other disposition of a business conducted by a corporation, amounts were paid with respect to stock or stock options previously issued to an executive of the corporation, and either the executive or the corporation sought more favorable tax treatment with respect to the amounts paid than would have been expected based on prior tax reporting positions by the same or related taxpayers. In both cases the government prevailed.

### ‘Greiner’

Jeffrey Greiner (Greiner) was President of Advanced Bionics Corporation (Advanced Bionics) and received stock options as part of his overall compensation. In 2004 Advanced Bionics became a subsidiary of Boston Scientific Corporation (Boston Scientific) through a merger.

In connection with the merger, stock options held by Greiner and others were vested and then canceled, and the option holders were offered a choice of (i) a one-time cash payment of \$21 per share minus the applicable option exercise price, or (ii) a package consisting of (a) a cash payment of \$11 per share minus the option exercise price, and (b) earn-

out payments contingent on the future performance of four product lines of Advanced Bionics, which earn-out would be payable over a period of nine years beginning in 2006. Greiner chose the package of cash and earn-out payments.

An information statement provided to the shareholders and option holders of Advanced Bionics stated that the corporate parties to the merger intended to take the position that the cash paid to an option holder at the time of the merger was compensation to the holder at the time of payment, and that earn-out payments paid to an option holder would be compensation as and when received (sometimes referred to as the “open transaction approach”). The statement also acknowledged uncertainty regarding the tax treatment of the earn-out payments.

In January 2008, and after earn-out payments had been received in 2006 and 2007 (which amounts were reported as compensation in the year of receipt consistent with the approach set forth in the information statement), Greiner and others settled litigation with Boston Scientific relating to the management and control of the Advanced Bionics business after the merger. As part of the settlement, the rights of the former option holders to earn-out payments contingent on financial results were converted to rights to fixed amounts that would be paid in two installments in 2008 and 2009. The amounts paid pursuant to the settlement were reported by Greiner as

compensation in the years the installments were received.

In 2011, Greiner filed amended tax returns for 2008 and 2009 seeking tax refunds for each of those years, on the basis of reclassification of the 2008 and 2009 payments as proceeds from the sale or exchange of a capital asset resulting in capital gain. The amended tax returns asserted that: the right to earn-out payments should have been included in Greiner’s income in 2004 based on its value at the time the right arose;<sup>3</sup> taking into account such required inclusion, the right to receive the payments was thereafter a capital asset under Internal Revenue Code (Code) section 1221; the amounts received in 2006 and 2007 remained taxable as ordinary income but only to the extent they exceeded the tax basis that would have resulted from inclusion of the right to earn-out payments in income in 2004;<sup>4</sup> and that the payments received in 2008 and 2009 should have been treated as proceeds from the sale or exchange of the right to earn-out payments pursuant to the settlement and therefore as resulting in capital gain.

When the IRS failed to grant the refund, Greiner brought suit in the Court of Federal Claims. After Greiner filed for summary judgment on his refund claims, the government cross-moved for summary judgment on three issues: whether the amended tax returns reflected a change in accounting method by Greiner for which consent had to be obtained

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from the IRS; whether the claims for refund violated a duty of consistency owed by Greiner; and whether the payments in 2008 and 2009 could not qualify for the more favorable tax rates applicable to long-term capital gains because the payments did not result from a “sale or exchange” of a “capital asset” as those terms are used in the Code.

Ultimately, the Court of Federal Claims agreed with the government that consent by the IRS to a change in accounting method would have to have been obtained by Greiner in order to obtain the refunds sought, and that such consent had not been properly requested or obtained. The court therefore did not address the other arguments made by the government.

Under IRC section 446(e), an accounting method adopted by a taxpayer generally cannot be changed without IRS consent. Greiner made several arguments to attempt to rebut the government’s position that the treatment sought by him with respect to 2008 and 2009 represented an impermissible change in an accounting method previously adopted by Greiner with respect to the earn-out payments.

One argument made by Greiner was that, under the relevant regulations, a change in accounting method includes an adjustment that affects “the proper time for the inclusion of the item of income,” but not, generally, an adjustment to the character of an item (such as from ordinary income to capital gain, or from a deductible business expense to a non-deductible personal item) that does not involve a change in the time of inclusion or deduction. Greiner asserted that the relief he sought involved changes in the character of income for the two years at issue but not any change in the timing of income for those years.

The government successfully countered, however, that the capital gain treatment sought by Greiner could be available only if the earn-out amount had been treated as property (for purposes of IRC section 83) includible in his income in 2004; and that, if that treatment (the “closed transaction” approach) had been followed, there would have been

changes in the amount of income reportable for 2004, 2006, and 2007, because Greiner would have had (i) additional income in 2004 and (ii) after 2004, basis in the earn-out right to take into account in determining his income in 2006 and 2007.

Greiner also argued for the application of various other exceptions to the general rule of IRS consent as a prerequisite to a change in accounting method. In particular, he asserted that the refund claims were within the scope of the rule in the regulations under section 446(e) to the effect that correction of a mathematical or posting error is not a change in accounting method, and/or the rule that a change in accounting method does not include a change in treatment resulting from a change in the underlying facts (with the settlement with Boston Scientific in 2008 being the asserted change); and that the 2008 and 2009 amounts were different items of income from the items of income with respect to which an accounting method had been adopted in earlier years.

The court found these arguments unpersuasive. It noted, in particular, that even if the settlement constituted a relevant change in circumstances, it occurred no earlier than 2007 and therefore could not justify a change in the treatment of the right to earn-out payments in 2004, as appeared to be necessary to support Greiner’s desired tax treatment of the payments received in 2008 and 2009 as resulting in capital gains. It was also noted that Greiner’s allegedly desired tax treatment of the transaction for 2004 could not be changed at the time he filed the amended returns because, under the three-year limitation of assessment period imposed by Code section 6501(a), additional tax could no longer be assessed with respect to 2004 at the time of filing of amended returns.

The court also observed that it did not need to resolve whether Greiner should have accounted for the earn-out payments under the closed transaction method from the beginning, because, as indicated by regulations and case law cited in the opinion, a change in accounting method requires IRS permission

even if the change is from an impermissible method of accounting to a permissible method.

The court’s opinion states at various points that Greiner, in 2004, “chose” or “elected” to take the earn-out payments into account under the open transaction approach, rather than by valuing the right and taking it into income as compensation in 2004. Given the treatment in regulations under Code section 83 of an unfunded and unsecured promise to pay money as something other than property,<sup>5</sup> it is far from clear that the tax law offered such a choice to Greiner or that the closed transaction method in particular would have been a permissible method under the circumstances. However, the court avoided the need to confront this issue by concluding that the open transaction approach followed by Greiner was a method of accounting that could not later be changed unilaterally by the taxpayer.

#### **‘Qinetiq U.S. Holdings’**

In *Qinetiq*, a corporation was incorporated in March 2002 by one shareholder who caused an S election to be made for the corporation. Stock in the corporation was issued to another individual in December 2002 in connection with his agreeing to employment as the executive vice president and chief operating officer of the corporation. Each of the founding shareholders accepted restrictions on his stock that included a provision calling for a fraction (5% for each full year of service) of the “agreement price” to be paid for the stock in the context of a corporate buyout right that would be triggered upon a voluntary resignation after a period of service of less than 20 years. (For example, a shareholder would receive only 5% of the “agreement price” for his stock if he resigned after one year of service.) That right appeared likely on its face to be a “substantial risk of forfeiture” (or SROF) as that term is used in Code section 83 and regulations under that provision.

In 2008, and after S corporation status had been terminated effective January 2007, the stock of the corporation was sold for \$123 million. The acquired

corporation or its affiliate claimed a compensation deduction of \$117 million under IRC section 83 in the fiscal year that included the date of acquisition, in part on the rationale that stock issued to the second shareholder in 2002 was subject to a SROF that did not terminate until the restrictions were waived in connection with the sale.

The IRS disallowed on audit compensation deductions attributable to the acquired corporation's stock. The corporation conceded that the stock issued to the first shareholder was not subject to a SROF, and the Tax Court ultimately sustained the disallowance of a compensation deduction with respect to the stock issued to the second shareholder as well.

The opinion asserted that the petitioner had failed to establish that the stock was transferred in connection with

the performance of services (a somewhat surprising conclusion under the circumstances) but described the crux of its analysis as relating to whether the restrictions imposed on the second shareholder's stock constituted a SROF. The court answered the latter question in the negative, largely because it concluded that the forfeiture condition was unlikely to be enforced.

The court cited, in support of its conclusion that the SROF was unlikely to be enforced, the large amount of the stock of the corporation owned by the second shareholder (almost 50%) and his importance to the operations of the corporation. The court also found to be relevant, however, that the two founding stockholders had effectively disregarded the restrictions on their stock for tax reporting purposes during the years in

which the corporation was an S corporation, by causing the corporation to allocate income to each of them on the basis that each was the owner of stock of the corporation for tax purposes. If the restrictions had constituted a SROF so as to cause the stock to be substantially nonvested for purposes of IRC section 83, the founders should not have been treated as the owners of the stock for S corporation income allocation purposes.<sup>6</sup>

Both *Greiner* and *Qinetiq* underscore the likelihood of a successful challenge by the IRS where a tax benefit is sought that is inconsistent with the tax positions of the taxpayer or related parties in earlier years.

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<sup>1</sup> 116 AFTR 2d 2015-5324.

<sup>2</sup> TC Memo 2015-123.

<sup>3</sup> The 2004 value of the right to earn-out payments was estimated in the amended returns as \$10 million, which may have been determined by reference to the difference in up-front cash payments offered to option holders who accepted or declined the right to earn-out payments.

<sup>4</sup> So far as appears from the decision, neither the government nor the court raised the question of whether, if Greiner had prevailed in his argument that the right to earn-out payments should have been taxed in 2004 based on its value at the time of the merger, any amounts received with respect to that right that exceeded the amount taken into income in 2004 should be characterized in part as interest and in part as additional proceeds from an exchange, under the authority of IRC § 1271(a)(1) and the regulations under IRC § 1275 relating to contingent payment debt instruments.

<sup>5</sup> See Reg. § 1.83-3(e).

<sup>6</sup> See Reg. § 1.1361-1(b)(3).