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Sham Stock Sales: Acqis Technology v. Commissioner

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Transactions that do not have any non-tax business purpose or economic substance apart from the creation of tax benefits may be disregarded, and additional tax determined by the Commissioner on the basis of the underlying economic substance of the transactions, under the "economic substance" doctrine as developed by the courts and as codified in Internal Revenue Code section 7701(o). *Acqis Technology, Inc. v. Commissioner* (TC Memo 2024-21), discussed below, confirms the continued vitality of the doctrine in the context of an apparent scheme to evade tax with respect to proceeds attributable to the settlement of patent infringement claims.

Facts in *Acqis*

Acqis Technology, Inc. (Acqis), a California-based corporation incorporated in that state, initially operated a computer hardware development and licensing business. The hardware business was sold in 2004. Thereafter, Acqis acquired additional patents, and engaged attorneys to prepare for patent infringement lawsuits against large technology companies to pursue patent infringement claims and licensing fees.

Acqis issued common stock and two classes of preferred stock for cash. In late 2010 and 2011, the initial common stock and the preferred stock were all converted to Class A common stock (referred to in the opinion of the Tax Court and below as the Investment Shares) and Class B Common Stock (the Settlement Shares) was authorized. In addition, Acqis reincorporated in Delaware, which offered greater flexibility in regard to establishing dividend rights and liquidation preferences.

As part of the reincorporation Acqis made changes to the distribution rights, liquidation preference, and voting rights of its various classes of stock, such that it could make distributions with respect to Investment Shares without making distributions with respect to Settlement Shares. Voting rights were provided to the Investment Shares but not the Settlement Shares, and the Investment Shares received a liquidation preference equal to the proceeds from the lawsuits described below.

In 2009 Acqis commenced patent litigation against 11 companies. All of the defendants ultimately paid damages in negotiated settlements in the form of cash payments to lawyer trust accounts opened by Acqis attorneys, and the contingency fees paid to those attorneys were based on the amounts paid into the trust accounts.

Acqis made offers to each of the four defendants, referred to in the opinion as D1, D2, D3, and D4, that ultimately paid the largest amounts, to settle for a reduced amount if the defendant executed a share purchase agreement (SPA) under which the settlement amount would be characterized as payment for the issuance of Settlement Shares.

D1 entered into a SPA and accepted Settlement Shares. D2 and D3 also each entered into a SPA, but designated a third party (Susan G. Komen for the Cure ®) as the recipient of Settlement Shares. None of D1, D2, D3, or Komen received any financial information with respect to Acqis other than incorporation documents.

D4 declined to structure its settlement with Acqis as a share purchase, and, as a consequence, paid a larger settlement amount.

The settlements with D1, D2, D3, and D4 also included the dismissal of all related pending litigation and nonexclusive licenses to use the intellectual property of Acqis. Settlements with other defendants were mostly similar in structure except that the other defendants were not offered Settlement Shares.

The payments from D1, D2, and D3 were not reported as gross receipts on the Federal tax returns of Acqis, but the balance sheets included in its returns for its fiscal years ending in 2010 through 2012 showed increases in shareholder equity that roughly corresponded to the amounts received from those defendants. Payments from other defendants were included in gross receipts. The related legal fees paid by Acqis were reported as "costs of goods sold" on the returns and, in a statement attached to the returns, described as "legal settlement fees."

The IRS issued a notice of deficiency in 2017 asserting that the payments from D1, D2, and D3 were includible in income as gross receipts. Those adjustments resulted in tax deficiencies for the 2010 through 2012 fiscal years of Acqis and reduced its net operating loss carryovers, resulting in a further deficiency for its fiscal year ending in 2015. In addition, penalties were asserted under IRC section 6662(a).

Discussion

Under IRC section 61(a) and cases cited in the *Acqis* opinion, gross income generally includes royalties and payments received in settlement of patent infringement claims. Conversely, under IRC section 1032 and Treasury Reg. section 1.1032-1(a), no gain is recognized by a corporation upon the issuance of its stock in exchange for money or other property.

The government's position, in brief, was that the SPAs were "economic shams," and that the payments received by Acqis from D1, D2, and D3 were received in settlement of patent infringement claims and as licensing fees, and not in exchange for stock. Cases decided by the Court of Appeals for the Ninth Circuit and cited in the *Acqis* opinion focus on two factors in determining whether a transaction is an economic sham: (1) whether the taxpayer intended to achieve any result other than a tax benefit, and (2) whether the transaction has any practical economic consequence apart from the avoidance of tax.

The founder of Acqis testified that he understood that it would not have to pay taxes on the payments that were structured as share purchases. He further asserted, however, that Acqis sought to structure settlements with four technology companies with SPAs to enlist them as "partners," and that having these companies as shareholders would provide Acqis with greater credibility. The court found this explanation unconvincing, noting that the terms of the SPAs precluded Acqis from publicizing the settlement agreements or disclosing the names of D1, D2, and D3. Further, D2 and D3 did not, in fact, become Acqis shareholders.

The court also noted the founder's assertions that SPAs were not offered to the other defendants because the settlement amounts from the other defendants were very small, such that it would not be "worth the legal cost to go through" the SPA process with those defendants. The court found that explanation to be in conflict with the "partnering" explanation for the SPAs, noting that the size of a settlement with a technology firm should not affect any benefits in respect of corporate legitimacy that would be achieved through the issuance of shares to that firm; and concluded that Acqis did not have a business purpose for the SPAs apart from tax benefits.

To assess whether the SPAs had economic substance, the court relied on analyses of experts for Acqis and the government regarding the value of the Settlement Shares. Taking into account that the Settlement Shares lacked liquidation, voting, and distribution rights of the Investment Shares, that the Settlement Shares were not transferable without the consent of Acqis, and that Acqis had in fact refused to consent to requests to transfer, the government's expert asserted that the Settlement Shares were worthless.

The opinion also noted that there was no evidence of arm's length negotiation in establishing the price to be paid for the Settlement Shares (as opposed to the settlement of claims), and that, in determining the contingency fees payable to Acqis' attorneys, the amounts received in settlement were treated as attributable to patent enforcement, licensing transactions, and court awards, all subject to the contingency fee arrangement, rather than as proceeds from stock sales.

Regarding whether any defendant had acquired the benefits of ownership typically associated with corporate stock, the court noted that the defendants could not transfer their shares without the consent of Acqis, had no right to vote to elect directors or with respect to other matters, and did not receive Acqis financial information. The court concluded, based on the overall record, that the Settlement Shares had no economic value when received, and that the SPAs therefore had no economic substance and should be disregarded.

Taking into account the lack of any other indication in the settlement documents as to the allocation of the payments made, the court further concluded that the payments by D1, D2, and D3 should be treated as having been received for the settlement of patent infringement claims and for nonexclusive licenses, and were therefore taxable receipts to Acqis.

The amounts omitted from gross income on Acqis returns exceeded 25% of the gross income reported. Therefore, the court concluded, a six-year statute of limitations applied under IRC section 6501 with respect to the Acqis tax years ending in 2010 through 2012.

Acqis argued that the six-year period should not apply because the disclosure made on its returns was "adequate to apprise the Secretary of the nature and amount of such item" (IRC section 6501(e)(1)(B)(iii)). The court concluded, however, that the increases to shareholder equity shown on the balance sheet included in each of the returns and the disclosure of "legal settlement fees" was insufficient to communicate that there was (at least potentially) omitted income, and further concluded that the disclosures made were misleading as to the nature of the payments received.

The accuracy-related penalties asserted under IRC section 6662(a) were also sustained, taking into account that the understatements of income tax exceeded the threshold for a "substantial understatement" (generally, 10% of the tax required to be shown on the return); that there was no "substantial authority" for the positions taken; and that Acqis failed to established that it had reasonable cause for its position and acted in good faith. In particular, although its returns were prepared by an accounting firm, there was no indication that the accounting firm had been made aware as to why the transactions were structured as sales of stock, or that the accountants were asked to provide advice as to the proper treatment of the transactions.

Observations

Footnote 14 of the *Acqis* opinion indicates that the government was not relying on IRC section 7701(o), which codified the application of the economic substance doctrine for transactions entered into after March 30, 2010. In another recent decision, however, regarding a tax-motivated transaction, the U.S. District Court for the District of Colorado granted the government's motion for summary judgment to the effect that the economic substance doctrine as codified in section 7701(o) applied to deny a refund claim that was premised on the availability of a dividends received deduction under IRC section 245A as a result of a series of transactions intended to generate earnings and profits for tax purposes (*Liberty Global, Inc. v. United States*, 132 AFTR 2d 2023-6406).

It seems apparent that the economic substance doctrine will remain an important part of the government's tool kit in challenging tax-motivated transactions.

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