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Taxpayer Prevails on Substance over Form: *Complex Media, Inc. v. Commissioner*

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A taxpayer, like the Internal Revenue Service, may argue that the form of a transaction is different from its substance, and that the substance should govern the tax consequences of the transaction. Since the form is typically specified by documents drafted with the participation of the taxpayer, courts have developed doctrines that often dismiss substance-over-form arguments made by taxpayers. In *Complex Media, Inc. v. Commissioner* (T.C. Memo 2021-14), however, a corporate taxpayer that acquired a business in exchange for stock and other property prevailed over the IRS, on the basis of an argument that the substance of the transaction was different from its form, and was allowed to claim amortization deductions attributable to a basis step-up arising from the substance of the transaction.

Facts

Complex Media Holdings, LLC (CMH), a partnership for tax purposes, was the holding company for two subsidiaries that published a magazine and engaged in related online activities. OnNetworks, Inc. (ONI) was identified as a potential provider of funds needed for these activities. Because of a prior unsuccessful business venture, the cash available to ONI was less than the liquidation preference of ONI's outstanding preferred shares, and the combination of ONI with CMH was therefore negotiated between CMH and ONI's preferred shareholders. During negotiations, friction developed between Seth Gerszberg, a member of CMH, and the preferred shareholders of ONI, and it was agreed that a portion of the ONI cash would be used to redeem Mr. Gerszberg's interest in CMH.

Ultimately, the documents for the transaction, all dated as of November 25, 2009 (the closing date), included an asset purchase agreement pursuant to which the assets to be transferred were acquired by CMH from its subsidiaries, a merger and contribution agreement (the CM & JV Agreement), a stock repurchase agreement, and a unit purchase agreement to redeem Mr. Gerszberg's interest.

Complex Media, Inc. (CMI) and a subsidiary were formed for purposes of the transaction. The CM & JV Agreement provided for the merger of the subsidiary into ONI, with the ONI preferred shareholders surrendering their stock in exchange for preferred stock in CMI, the previously outstanding ONI common stock being canceled for no other consideration, and CMI's stock in the acquisition subsidiary being converted into new ONI common stock pursuant to the merger. Simultaneously, CMH was to contribute the business assets to CMI in exchange for 4,999,000 shares of common stock of CMI.

Under the stock repurchase agreement, 1,875,000 shares of the CMI common stock issued under the CM & JV Agreement to CMH were redeemed for $3,000,000, of which $2,700,000 was paid at the closing and the balance of $300,000 was paid in 2011. The only stock certificate issued by CMI to CMH in connection with the closing of the transaction reflected the shares of common stock of CMI that remained outstanding after giving effect to the redemption and to the issuance of 1,000 shares of CMI stock apparently outstanding before the closing.

Under the unit purchase agreement, Mr. Gerszberg sold his equity interest in CMH to that company in exchange for payment of $2,700,000 at closing and assignment to him of CMH's right to receive an additional $300,000. An amendment of the operating agreement of CMH executed shortly before the closing provided that, to the extent gain was recognized by CMH by reason of the receipt of money or other property used to redeem a member’s units in CMH, CMH would allocate that income or gain to the redeemed member.

The 2009 partnership return of CMH did not reflect its receipt of $2,700,000 of cash and the right to a further payment of $300,000. However, Mr. Gerszberg reported gain from the redemption of his interest in CMH in 2009, computed by taking into account the consideration received in that year of $2,700,000, and an additional $300,000 in 2011 as “other income” received from CMI.

Disclosures under Treasury Reg. section 1.351-3 included in the returns of CMH and CMI stated the fair market value of the transferred assets as $8,000,000 and the aggregate basis of those assets (determined immediately before the transfer) as $237,702. The 2009 CMH return reflected amortization deductions of $4,808 attributable to trademarks and a domain name. The returns for CMI for the four years at issue (2010 through 2013) included amortization of $4,808 attributable to carryover basis from CMH, and an additional $200,000 of amortization attributable to amortization of an additional intangible asset acquired for $3,000,000 (i.e., the amount paid for the redeemed shares).

The IRS disallowed the entire $204,808 of amortization deductions claimed by CMI attributable to assets acquired from CMH, and asserted that CMI had not established that there was any increase in basis of intangible assets as a result of the 2009 transactions.

Discussion

The Tax Court opinion first discussed whether the transfer of assets to CMI, which (notwithstanding the simultaneous "merger") did not qualify as a reorganization under Internal Revenue Code section 368, constituted a transfer of assets in exchange for stock and non-stock “boot” within the scope of IRC section 351(a), or a fully taxable transaction.

The court expressed doubt as to whether the transaction met the requirement of section 351(a) that the transferors of property to a corporation be in control of the transferee immediately after the exchange, as the common stock of CMI issued to CMH accounted for less than 80% of the aggregate voting power of the stock of CMI, and the voting preferred stock of CMI was not issued, at least in form, in exchange for property transferred to CMI.

CMI argued that the result of the transaction was the same as if the ONI preferred stock had been transferred to CMI for preferred stock of CMI, and therefore that the control requirement was satisfied. Since neither the government nor the taxpayer contested the applicability of section 351(a), the court decided to treat the transaction as a section 351 exchange for purposes of the disposition of the issues before it.

The court then concluded that CMI acquired intangible assets from CMH, the basis of those assets could be amortized over 15 years under IRC section 197, and that CMI was entitled to amortization deductions at least to the extent of the "carryover basis" in amortizable section 197 intangibles acquired from CMH.

The principal obstacle to the full amortization claimed by CMI, attributable to the non-stock consideration of $3,000,000 paid by CMI to CMH and then by CMH to Mr. Gerszberg, was that, in form, the only consideration received by CMH for the transferred assets was common stock of CMI, a transaction form that would not give rise to any increase in the basis of the intangible assets acquired by CMI. The redemption of some of those shares for $3,000,000 was, in form, separate, albeit part of an overall plan and agreed to before any transfer of assets to CMI.

The court characterized CMI's position that the non-stock consideration was received as part of the original transfer of assets to CMI as a disavowal of the transactional form expressed in the CM & JV Agreement and the stock repurchase agreement, and noted cases (cited in the opinion) often cited for the proposition that a taxpayer may not disavow its chosen form. The court ultimately concluded, however, that CMI was correct that the tax consequences must be determined in accordance with the economic substance of the transaction, and that, at least in the circumstances of the present case, this economic substance rule could be invoked by the taxpayer.

Among the factors of significance to the court was that CMI's disavowal of the form did not raise any whipsaw potential, as the full amount of gain to CMH arising on the recharacterized transaction had been taken into account by Mr. Gerszberg, albeit (erroneously) attributed by him entirely to the redemption of his interest in CMH, rather than to his distributive share of gain of CMH. The section 351 disclosures made with the 2009 returns of CMH and CMI, and the change to the CMH operating agreement to specially allocate gain to Mr. Gerszberg attributable to CMH's receipt of boot also supported CMI's position.

Finally, the court concluded that the application of the step transaction doctrine, to treat the boot as consideration received for the transferred assets rather than as stock redemption proceeds, was appropriate in this case. CMI was not asking the court to "invent new steps," but simply to disregard an issuance of shares to the extent it was immediately undone pursuant to a previously agreed to redemption of shares. The fact that CMH as the transferor did not report the gain that it should have reported under section 351 (and then specially allocated to Mr. Gerszberg) did not prevent CMI from obtaining a step-up in basis under IRC section 362(a).

Although the non-stock property was received as boot as part of the consideration for the transferred assets, the court found CMI's computation of the basis adjustment from the recognition of gain in the section 351 transaction to be deficient. Where boot is received, the gain recognized must be determined on an asset-by-asset basis, with the consideration received being allocated among the assets in proportion to their relative fair market values. CMI had not obtained an appraisal of the assets at the time of the transfer, and the government argued that the evidence before the court was insufficient to estimate the appropriate basis.

The court concluded, however, that there was sufficient evidence for it to make an allocation based on estimated values, consistent with the rule derived from *Cohan v. Commissioner* (39 F.2d 540 (2d Cir. 1930)), and that, in light of the nature of the business, it would be unduly harsh to limit CMI's amortization deductions to the carryover basis amounts. It proceeded to make such an allocation based on the residual method mandated by IRC section 1060 for taxable purchases of assets constituting a business.

The absence of a valuation, however, was noted by the court as warranting that it "bear heavily" against CMI to the extent its estimates of fair market value lacked significant support. Thus, for example, the court refused to believe that tangible assets that had already been fully depreciated for tax purposes in CMH's hands had no remaining value and, instead, valued those assets at original cost. Further, the note included in the boot had to be taken into account at fair market value, rather than at its face amount. The court rejected CMI's suggestion that the note be discounted at the (very low) applicable federal rate (AFR) in effect for November 2019, as determined by Treasury on the basis of yields of marketable securities of the United States, given the credit risk associated with the debtor's obligation.

The note was instead discounted at the tax underpayment rate under IRC section 6621(a)(2) equal to the Federal short-term rate plus 3 percentage points. As this rate was established to avoid providing to taxpayers an incentive to delay the payment of taxes, it was, in the court's view, a closer approximation to the rate at which taxpayers may be able to borrow from sources other than the government.

Observations

The ultimate result was to allow amortization deductions very close to the amounts initially claimed by CMI, which appears appropriate based on the circumstances before the court. From a planning perspective, however, taxpayers considering similar transactions should endeavor to cause the form of the transaction to align as well as possible with the anticipated and intended tax treatment, to minimize uncertainty as to the tax consequences and the potential for expensive tax-related litigation.

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