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Coordination of ESOP Benefits with Installment Method

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When alternative structures to sell a closely held corporation are under consideration, a sale of stock to an employee stock ownership plan (ESOP) may offer tax benefits to the seller. Among those benefits is that a selling shareholder may, under IRC section 1042, avoid the recognition of gain by purchasing, within a specified period, "qualified replacement property" (QRP) -- in general, securities issued by a domestic operating corporation.

If the stock sold constitutes "qualifying securities," the cost of the QRP is not less than the amount realized from the sale, and certain other requirements are met, no gain will be generally recognized upon the sale, but the tax basis of the QRP will be reduced by the gain not recognized. During the years at issue in *Berman v. Commissioner* (163 T.C. No. 1 (2024)), the case discussed below, one of the requirements for qualifying securities was that the stock sold be shares of a domestic C corporation; this requirement will be somewhat relaxed for sales after 2027.

If a sale meets the requirements of section 1042, a valid election is made, and QRP is acquired within the required period, gain will be recognized thereafter under a recapture provision (section 1042(e)) when the seller disposes of the QRP. However, the recapture provision does not apply in certain circumstances, such as to a disposition by reason of death.

In *Berman*, two selling shareholders had sought to comply with the requirements of section 1042 in connection with a sale of stock for promissory notes, followed by the acquisition of QRP by each seller in the following year. However, they also entered into transactions with respect to the QRP that were eventually determined to be sales, for tax purposes, of the QRP in the very year in which it had been was acquired. This treatment of the QRP as having been sold required ***recognition*** of gain on the sale of the QRP in that year. However, the Tax Court agreed with the taxpayers that they were entitled to ***account*** for the recognized gain using the installment method of IRC section 453, under which gain may be deferred until the year or years in which payment is received.

Facts in *Berman*

Two cousins apparently each owned 50% of the stock of E.M. Lawrence, Ltd. (Ltd.). Each was issued convertible preferred stock by Ltd immediately before the transaction described below. On November 8, 2002, each sold the newly issued stock to the E.M. Lawrence, Ltd. Employee Stock Ownership Plan and Trust (ESOT) for a promissory note in the amount of $4,150,000. A payment of $449,277 (plus interest) was made to each seller in 2003 by the ESOT. Thereafter, principal payments of approximately $50,000 were made to each seller in 2004, but no further payments were received on the notes through 2009.

Ltd. reported as an S corporation for the first portion of 2002. The sellers signed shareholder consents to revoke the S election of Ltd. effective September 1, 2002 (the first day of Ltd.'s fiscal year), and the consents were mailed to the IRS with a letter from one of the petitioners, acting as the CEO of Ltd., dated November 13, 2002. The IRS responded with a letter confirming that the S election had been revoked effective September 1.

Each seller's tax return for 2002 included a statement that, as required by a regulation under section 1042 relating to nonrecognition of gain, identified the securities sold as qualifying securities, stated their adjusted tax basis (stipulated to be $27,428 for each seller), and showed the amount realized upon the sale of the securities as $4,150,000.

Each seller's tax return for 2003 disclosed the purchase of floating rate notes (FRN's) during October and November of 2003, in an aggregate amount approximating the proceeds from the 2002 sale of stock, as QRP under section 1042. The purchases were financed largely with margin debt. Later in the same month, the FRN's were transferred, subject to the margin debt, to an affiliate of Derivium Capital LLC. In cases cited in a footnote to the *Berman* opinion, transactions of a similar nature involving Derivium were determined to be sales for tax purposes. In 2012, the IRS issued to the petitioners notices of deficiency attributable to the treatment of their transactions with Derivium as sales; and, in the proceedings before the Tax Court in *Berman,* the petitioners conceded that those transactions resulted in sales of the QRP in 2003.

Discussion

The court characterized the parties' cross-motions for summary judgment as asking it to decide whether the elections made by the petitioners under section 1042 and the associated recapture provision of section 1042(e) precluded the petitioners from using the installment method under section 453 to account for gains recognized on disposition of the FRN's. If the section 1042 elections were effective, the petitioners' bases in the FRN's, as QRP purchased by them, would have been reduced by the amount of gain not recognized by virtue of section 1042(a), and, if section 453 did not apply, the gain realized for 2002 (that is, the sales price of $4,150,000 minus basis of $27,428) would then have been recognized as income in 2003 upon the disposition of QRP in accordance with section 1042(e).

The first argument made by the petitioners was that the election made in 2002 to terminate the S election of Ltd. was ineffective, because the election was required to be consented to by shareholders owning more than 50% of the stock of the corporation. The election was mailed after the stock sale, at a time when the sellers no longer owned more than 50% of the stock of Ltd. Accordingly, the petitioners argued, the stock they sold was stock of an S corporation and section 1042 could not apply.

The IRS argued that the petitioners, having consented to the revocation of the S election and filed their personal tax returns for 2002 on the basis of the revocation's being effective, were precluded by the so-called "duty of consistency" (or "quasi-estoppel") from now arguing that the revocation was not effective. The court agreed, noting that: the petitioners' tax returns for 2002 represented that the S election had been revoked prior to the sale; the Commissioner relied on those representations in accepting the 2002 returns as filed and not auditing them; and that the IRS was now precluded from assessing additional tax for 2002 by application of the statute of limitations.

A note to the opinion further concludes that, even if revocation of the S election by shareholder consent was not effective, the issuance to the sellers, on November 8, 2002, of the preferred stock sold by them to the ESOT would have terminated the status of Ltd. as an S corporation effective as of the end of the preceding day, and prior to the sale.

The petitioners' second argument was that the section 1042 elections made by them were ineffective because the elections were based on material mistakes of fact. A temporary regulation under section 1042 provides that a section 1042 election is irrevocable. However, as noted in the opinion, some courts -- including one to which a petitioner in *Berman* could have appealed -- have held that a taxpayer may avoid an otherwise irrevocable election made based on material mistakes of fact.

The Tax Court concluded, however, that the circumstances cited by the petitioners -- that they were mistaken as to the value of the notes, did not anticipate the apparent inability of Ltd. to satisfy those obligations in later years, and were "fraudulently induced" by advisors to make elections based on a mistaken understanding of the legal consequences -- were not mistakes of fact of the nature that could justify revocation of their section 1042 elections.

The court then considered whether the petitioners should (as they asserted) recognize the gains recaptured under section 1042(e) in a manner that reflected the continued application of the installment method. It was apparently undisputed that, but for any consequences of their section 1042 elections, the petitioners' sales of stock qualified under section 453 as installment sales.

Section 453 applies to an installment sale unless the seller elects for it not to apply. A seller may make this election by reporting an amount realized equal to the selling price, including the face amount of any installment obligation received, on its tax return for the year in which the sale occurred (Reg. §15A.453-1(d)(3)(i)). Although the statements of election under section 1042 included in the sellers' returns for 2002 included that information, the Commissioner did not argue to the court that the petitioners made elections under section 453 for the installment method not to apply.

The Commissioner argued that each petitioner, in electing to defer all of that petitioner's respective gain under section 1042, caused there to be no remaining gain to which section 453 could apply, and that such a section 1042 election supplanted section 453. Thus, once the section 1042 election was made, the recapture provision of section 1042(e) became the exclusive means for determining when the gain deferred under section 1042(a) would be recognized. The Commissioner emphasized that section 1042(e) by its terms applies "notwithstanding any other provision of this title."

The Tax Court characterized this as an issue of first impression, and ultimately disagreed with the Commissioner. Taking into account that the installment method, as codified in 1980, predates section 1042 as currently in effect, the court characterized its task as determining whether the two provisions could be reconciled. The court concluded that, based on a close reading of section 1042, it was appropriate to reconcile the two provisions by reducing the basis of QRP under section 1042(d) only as and when gain would otherwise be recognized under the installment method.

In particular, when a principal payment of $449,277 was received by each seller in 2003, the basis of the seller's QRP was reduced under section 1042(d) by the amount of gain otherwise required to be

recognized under the installment method by reason of that receipt ($444,784), to $3,705,216. Upon the deemed sale of QRP in the Derivium transaction that same year by each petitioner, the resulting gain was the excess of the proceeds from that sale over the petitioner's adjusted basis in the QRP. Thereafter, when each petitioner received an additional payment from the ESOT in 2004, the section 1042 election would no longer operate to defer gain (because the petitioner no longer owned any QRP), but gain would be recognized and reported as otherwise required under the installment method.

Observations

The Tax Court ultimately reached a pro-taxpayer result in *Berman*. However, the conclusion of the court that the installment sale rules continued to apply where a section 1042 election had been made is surprising, at least to the authors of this article, and it remains to be seen whether the Commissioner will contest this result.

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