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Tax Officer Failed to Write His Own Opinion

The Tax Court applied the economic substance doctrine in *Gerdau MacSteel, Inc.*, 139 TC No. 5 (August 30, 2012), and denied penalty relief in a liability management company "tax shelter" case because the company's tax department failed to either obtain an outside opinion or write its own.

Facts

Gerdau MacSteel enjoyed a large capital gain in 1996 and its accountants brought to its attention a way to "create" a large, offsetting loss. The technique is now well known: incorporate future medical and environmental liabilities to be funded by a note from one of the member companies, claim that the liabilities should not be taken into account to reduce the basis of the stock and sell the stock at a loss to the people who would manage the liabilities on the theory that stock ownership would incentivize their cost savings.

Nonqualified Preferred Stock

The court's rejection of the loss deduction was based primarily on a determination that the stock received for the note and sold for the loss was nonqualified preferred stock under Section 351(g), and so did have a high stock basis because it was treated as boot. The opinion did not discuss why this would cause the taxpayer to lose, but the explanation is as follows: when nonqualified preferred stock is received in a Section 351 exchange, it is treated as boot. That means the shareholder takes a basis in the stock equal to its value. Because its value was minimal, the basis was minimal, and when the taxpayer sold the stock for a minimal amount, it did not recognize a large loss.

Planning Point

The court's reasoning in finding the stock to be preferred could be the most significant aspect of the case. The part of the definition of nonqualified preferred that was at issue was the requirement that it not participate in corporate growth to any significant extent.

Tax professionals have long debated how to define such participation, given the fact that the requirement is not further defined for Section 351(g) purposes. The court adopted the Section 305 regulation definition for the simple reason that the parties so agreed because similar words are used. It also relied on Section 1504(a)(4). Whether or not this is a correct legal analysis is debatable, but was not made an issue by the parties.

The CPA had tried to fashion a right in the stock that would serve to provide participation in growth of the liability management company. The right was an unusual one (though typical of these deals): the stock would be redeemed at a price that could reflect cost savings presumably resulting from efforts of the shareholder/employees.

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The court deconstructed the formula and found that it did not provide profit participation for two reasons: (1) the court did not view cost savings as profit participation, even though controlling costs was pretty much the only way the company could profit, since it had a fixed income; and (2) it did not believe as a matter of fact that even the cost savings would produce a return for the shareholders above the fixed redemption price.

Planning Point

Analogous, but obviously not similar, formulas are used in a variety of situations for stock that is either intended or not intended to be preferred. The suspicion applied by the court to the formula and the court's willingness to investigate closely how the formula would actually work out should caution those who rely on such formulas.

Economic Substance Doctrine

Despite having already denied the loss, the court felt obliged to apply the economic substance doctrine to deny deductions for the fees, which it did. This section of the opinion was pretty standard: cites to the usual opinions, finding of no business purpose and no possibility of making money.

Reasonable Cause Exception to Substantial Understatement Penalty

The court refused to relieve the taxpayer of the penalties. The CPA firm had provided a draft opinion that was never finalized. The taxpayer had several in-house tax officers with considerable expertise. The court criticized them as follows:

- failed to obtain a final opinion from the CPA,
- failed to perform their own written in-house legal analysis,
- failed to discuss the legal issues with the CPA,
- had to know that there was no purpose for the transaction other than tax savings, and
- had to know that assumptions in the draft opinion were false.

Planning Point

The opinion is somewhat unusual in seeming to place a requirement on in-house tax officers to create their own written legal analyses of the tax issues. Therefore, taxpayers that forego outside legal opinions should consider creating their own in-house opinion.

For more information, please contact Jack Cummings at (919) 862-2302.

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