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Larry's Tax Law

You Cannot Have Your Cake and Eat it Too

By Larry Brant on 12.30.13 | Posted in Stock Basis

In the case of ***John D. Moore, et al. v. Commissioner***, TC Memo 2013-249 (October 30, 2013), the US Tax Court was presented with the saga of John Moore.

Mr. Moore was a CPA. He left the world of public accounting to embark on a career in a new industry. In 1992, he became the Operations Manager of the Dallas, Texas Peterbilt truck distributor. By 1995, Mr. Moore had climbed the corporate ladder and was appointed president of the company.

In 1992, the company granted Mr. Moore an option, good through December 31, 1999, to purchase five percent (5%) of the shares of the company, an S corporation. In 1997, the company merged with another company. As a result of the merger, Mr. Gary Baker entered the picture. Mr. Baker ended up with 1,477,859 shares of the merged entity. On December 30, 1999, Mr. Moore entered into an agreement to purchase all of Mr. Baker's shares for $5,842,606. The next day, on December 31, 1999, Mr. Moore timely exercised his option and purchased 500,000 shares of the company for $212,334.

As part of the purchase of the Baker shares, Mr. Moore signed a promissory note for the full purchase price of an amount just shy of $6,000,000. It was all due and payable on May 5, 2000. After signing the note, however, the parties revised it so that $3,000,000 would be due on June 14, 2000, and the balance would be paid in three equal annual installments.

Moore had the corporation make the payments on the note to Mr. Baker. He claimed the corporation was lending him the money pursuant to some sort of line of credit arrangement. Interestingly, a promissory note existed which evidenced the loan arrangement, but it was not executed until sixty (60) days after the corporation had already made the payments to Mr. Baker.

In 2002, Mr. Moore, who had not paid a dime on the loan, sued the corporation to rescind the loan. He argued that he entered into the stock purchase agreement with Mr. Baker at the insistence of the corporation and that the shares had been way overvalued by the corporation.

The lawsuit was a heated battle, but the parties eventually managed to settle the case. They agreed:

- The corporation had already advanced Moore $5,357,582 on the line of credit;
- Mr. Moore owes $571,706 of accrued interest;
- Mr. Moore had repaid zero on the loan;
- The true value of the shares at purchase was really $1,000,000 (not $5,842,606); and
- The loan amount shall be reduced to $1,000,000, and the interest shall be adjusted accordingly.

It is interesting to note that Mr. Baker was not a party to the lawsuit. He did not agree to reduce the current amount owing, nor did he agree to return any of the amounts already paid. In fact, Mr. Baker ended up receiving all $5,842,606, plus interest.

In 2005, Moore sold his shares for $3,000,000. BDO Seidman CPA Catherine Fox reported a capital loss of about $1,500,000 from the sale of shares on Mr. Moore's tax return. She claimed Moore's stock basis was around $4,500,000.

The Service, on audit, disagreed with Ms. Fox and Mr. Moore. It claimed Mr. Moore's basis in the stock was actually $1,000,000. So, rather than generating a capital loss of $1,500,000, the transaction had actually generated a capital gain for Moore of around $2,000,000. In addition, the Service assessed a Section 6662 accuracy-related penalty. Together, the tax and penalty amounted to almost $1,000,000.

The parties lawyered up and went off to tax court. Judge Thornton heard the case.

Mr. Moore's position was that his cost basis in the shares was about $6,000,000, namely, the $5,842,606 that Baker was paid and the $212,334 he had paid for his option shares.

The Service's position was that the Mr. Moore's basis in the shares was only $1,000,000 as that was the amount he actually owed the corporation on the line of credit loan. The Service totally ignored the consideration Moore paid for the option shares of $212,334.

If Baker did not reduce the purchase price and return the proceeds over $1,000,000 back to the corporation, why didn't Moore have cancellation of indebtedness income? I guess this issue was not examined by the court as the parties agreed as part of the civil litigation resolution that the true value of the shares was $1,000,000. This is an interesting conclusion

because the seller, Mr. Baker, was not a party to that litigation. Nevertheless, the court ignored that issue.

If Moore didn't have cancellation of indebtedness income, why should he get to add the amount (almost $5,000,000) he didn't have to repay on the loan to the corporation? It sure seems logical that he should not get to get the benefit of the reduction in the loan debt since he did not have COD income.

Judge Thornton agreed with me. You can't have your cake and eat it too. In other words, you cannot have a basis in an amount greater than $5,000,000 when your true economic outlay was only $1,212,334, without COD income for the amount written down on the loan.

The court concluded:

- The amount paid for the option shares must be included in the Taxpayer's stock basis;
- There was no COD income because the debt amount between the corporation and the Taxpayer was in dispute;
- Moore's basis in his shares was not north of $5,000,000; rather, it was $1,212,334, which represents the amount paid for the option shares and the $1,000,000 owed to the corporation.
- Relative to the Section 6662 penalty assessment, since Moore relied in good faith upon a professional tax advisor, BDO Seidman, Judge Thornton threw out the penalty assessment.

Strange case; probably the correct outcome!

Tags: COD income, Stock Options, US Tax Court