



DAILY TAX REPORT



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Payments by Majority Shareholders to Minority Shareholders To Secure Change in Control: Ordinary Income or Capital Gain?

By PEDRAM BEN-COHEN

Mergers, acquisitions, liquidations, and other major actions (Change in Control) by corporations frequently require a relatively high majority vote by all shareholders to be effected.

Usually the majority shareholders are the proponents of the proposed Change in Control and they may need the minority shareholders to approve the transaction as well.

Occasionally, the majority shareholders will make a payment, known as a "side payment," to the minority shareholders to have them vote in favor of the contemplated Change in Control. In effect, the majority shareholders "buy" the votes of minority shareholders with side payments.

This article discusses whether these side payments should be taxed to minority shareholders as ordinary income or as capital gain.

Analysis

Although the law regarding side payments is unsettled, two views have emerged in the tax law concerning these payments:

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■ The Internal Revenue Service view is that each payor is deemed to receive the amount it is entitled under state law in a transaction (such as a reorganization or a liquidation), and side payments are considered separate consideration unrelated to the transaction, the treatment of which is based on all facts and circumstances.

■ The Tax Court view is that side payments can relate to the underlying transaction in such a way that they can be considered additional consideration to payees in exchange for their stock.

IRS Position Seen in Pair of Rulings. The IRS position is contained in a pair of revenue rulings relating to side payments in the context of a reorganization and a liquidation.

In Rev. Rul. 73-233,¹ a 60 percent majority shareholder made a capital contribution (the side payment) of his target stock to target in anticipation of a tax-free merger. The state law required a two-thirds (67 percent) vote of approval and the 40 percent minority shareholders demanded and received 50 percent of the merger consideration to agree to the merger. This allocation was implemented by having the majority shareholder contribute, immediately prior to the merger, the required number of shares that would reduce his interest in the target to 50 percent.

¹ 1973-1 C.B. 179.

Minority shareholders generally have two main rights with respect to the ownership of their stock—economic rights and voting rights—and both rights determine the total value of their stock.

IRS treated the majority shareholder as receiving its state law-entitled 60 percent of the merger consideration tax-free, and then as transferring to the minority shareholders 10 percent of the merger consideration in exchange for voting in favor of the merger.

IRS viewed the second step as a taxable sale under Section 1001 of the Internal Revenue Code. In addition, IRS allowed the majority shareholder a positive basis adjustment in his remaining shares equal to the fair market value of the shares exchanged with the minority shareholders. The minority shareholders were treated as receiving ordinary income equal to the fair market value of the additional shares they received, which then became their basis in those additional shares.

Commenters have questioned the validity of Rev. Rul. 73-233 because the side payment was made in exchange for a right relating to the ownership of stock, and thus should have resulted in capital gain recognition to the minority shareholders.²

Minority Shareholder Rights. The minority shareholders generally have two main rights with respect to the ownership of their stock and both rights determine the total value of their stock. The first right is economic rights—the right to receive dividends, the right to liquidation proceeds, and the potential increase in value of the stock upon its sale. The second right is voting rights—the right to vote for major decisions of the corporation, vote for the board of directors, etc.³

Because the side payment was made with respect to one of the bundle of rights the minority shareholders had as owners of stock, they should have been entitled to capital gain treatment.

Commenters have also questioned the ruling because it assumes that the majority shareholder's interest in the Target was worth 60 percent of the merger consideration. But this assumption is contrary to the fact that the minority shareholders could block the majority shareholder from receiving 60 percent, at least in connection with a merger transaction. The majority shareholder could at best receive 50 percent, which should be its full value.

The IRS position is also demonstrated in Rev. Rul. 79-10,⁴ where it ruled that a non-pro rata liquidation should be treated as two separate transactions:

² See, e.g., Ginsburg and Levin, *Mergers, Acquisitions, and Buyouts*, Paragraph 701.5 (2004) (calling the ruling “questionable”).

³ See Rev. Rul. 83-120, 1983-2 C.B. 170 (right to disapprove of a transaction is a component of stock valuation); Rev. Rul. 81-282, 1981-2 C.B. 78 (“right to vote is inherent in the ownership of common stock and, as such, is a property right”).

⁴ 1979-1 C.B. 140.

■ as a pro rata liquidation based on each shareholder's entitled interest in the corporation's assets giving rise to full payment in exchange for each shareholder's stock, and

■ as a separate payment (the side payment) by the majority shareholder to the minority shareholders equal to the excess the minority shareholders received over their pro rata share.

Facts and Circumstances Analysis. IRS stated that the characterization of the side payment would be determined by the underlying nature of the payment, which in turn depends on all relevant facts and circumstances.

IRS's facts and circumstances analysis stemmed from an internal memorandum where it instructed its agents to analyze the real reason for side payments and the true motivation of all parties in a transaction, which includes such payments. For example, side payments may be a gift, compensation for services, to protect a business's reputation, in settlement of potential claims, etc.⁵

Rev. Rul. 79-10 is different from Rev. Rul. 73-233, however, because the majority shareholder in Rev. Rul. 79-10 had the power under state law to effect the liquidation and could have received his pro rata share but decided not to “for various reasons.” In Rev. Rul. 73-233, IRS ruled that a side payment made in exchange for the minority shareholders cooperation with a merger was considered ordinary income. In Rev. Rul. 79-10, IRS stated that the tax consequences to the minority shareholder would be based on the reason for the side payment in light of all facts and circumstances.

Although this distinction exists, the rulings are still consistent with each other.

Tax Court Reasoning. Unlike the position taken by IRS, the Tax Court has held that side payments are treated as additional consideration to payees in exchange for their stock because they stem from the underlying transaction.

For example, in *Delong v. Commissioner*,⁶ a majority shareholder paid the taxpayer, a minority shareholder, \$14,000 “out of his own money” to secure his cooperation in a merger he was negotiating. A tax-free merger was effected and the taxpayer received stock of the acquiring company and \$14,000 (the side payment).

IRS argued that the side payment should be treated as ordinary income to the taxpayer because it was paid by the majority shareholder and not the acquirer, it was not part of the merger agreement, and none of the other shareholders of the target received a similar payment. The taxpayer, on the other hand, argued the side payment should be treated as additional consideration received as part of the merger.

The Tax Court agreed with the taxpayer and held that the side payment plus the acquiring company stock was the total consideration received by the taxpayer in the merger. Additionally, the excess consideration over the taxpayer's basis in the target shares was considered capital gain. But to the extent the taxpayer received the acquiring company's stock based on a tax-free reorganization, that portion of the realized gain was not subject to capital gain recognition.

The Tax Court explained its holding by stating, “There is no requirement of which we have been made

⁵ Gen. Couns. Mem. 37,649 (Aug. 25, 1978).

⁶ 43 B.T.A. 1185 (1941).

aware that the sales price of an article cannot be paid in whole or in part by one other than the vendee.”⁷

The commissioner acquiesced in this conclusion and has not withdrawn its acquiescence.⁸

Holding in ‘Gidwitz.’ Like its decision in *Delong*, the Tax Court in *Gidwitz v. Commissioner*,⁹ held that a \$225,000 payment (the side payment) received by a minority shareholder in settlement of a lawsuit based on a reorganization represented additional consideration received in the merger.

The taxpayer was the minority shareholder who entered into an oral agreement with the majority shareholder. Similar to the IRS position in its internal memorandum discussed above, the Tax Court sought to find out the underlying reason for the side payment. The Tax Court found that the majority shareholder agreed to grant the taxpayer options to purchase certain real estate in exchange for the taxpayer agreeing to cooperate with a merger.

After the merger was effected, the majority shareholder did not execute the options on behalf of the taxpayer and the taxpayer sued the majority shareholder. The lawsuit settled and the taxpayer received an additional \$225,000.

Similar to its position in *Delong*, IRS argued that the side payment should be taxed as ordinary income in consideration for the taxpayer agreeing not to vote against the merger.

The Tax Court held that the side payment was additional consideration received by the taxpayer in ex-

change for its stock pursuant to the merger, and thus should be taxed as capital gain.

Conclusion

Assuming a side payment is made to a minority shareholder, upon a challenge by IRS the service would argue that the side payment is like the contribution of stock made by the majority shareholder in Rev. Rul. 73-233. And thus, the tax consequences of that ruling should apply.

Conversely, a minority shareholder would argue the payment he received was made with respect to his rights as a shareholder to transfer or sell his stock. So the side payment should be treated as additional consideration relating to the underlying Change in Control event, resulting in capital gain.

While *Delong* was decided in 1941 and the rulings and *Gidwitz* were decided in the 1970s, a court should still take the position followed by the Tax Court. The reason is IRS acquiesced in the conclusion of *Delong* and has not withdrawn its acquiescence.

Additionally, while *Delong* and *Gidwitz* represent cases decided by the Tax Court, the rulings only represent IRS’s interpretation of the tax law.¹⁰ As a result, the tax consequences described in the cases have a higher chance of applying to a side payment than the rulings.

Accordingly, side payments to minority shareholders should be taxed as capital gain.

⁷ Id. at 1187-1188.

⁸ See 1941-1 C. B. 3.

⁹ 61 T.C. 664 (1974).

¹⁰ Treas. Reg. Section 601.201(a)(6) (Revenue rulings are an “official interpretation by the Service . . . and are published for the information and guidance of taxpayers”).