A SWITCH IN TIME: THE SIXTH CIRCUIT EXAMINES THE LIMITATIONS PERIOD FOR THE PROHIBITED ALLOCATION EXCISE TAX

Posted on **September 15, 2015** by **Jim Malone**

Congress has long favored employee stock ownership plans (ESOPs) and it has created tax incentives to promote them. But a troubling pattern emerged: a small business owner, such as a lawyer or an accountant in a solo practice, would convert her business into an S Corporation. Then she would contribute all of the shares to an ESOP, which would allocate the shares to the owner's retirement account. The income generated in the practice passed through to the ESOP untaxed because the practice was an S Corporation. The ESOP was exempt from tax at the plan level, and the owner was exempt from tax on the income associated with the stock until the stock was distributed to her at retirement. Thus, all of the S Corporation income went untaxed until the owner retired and received her shares.

Congress understandably concluded that this type of arrangement did not provide the type of benefit to rank and file workers that it had in mind. Accordingly, in 2001 it responded by imposing an excise tax on plans that fit this mold, and the Sixth Circuit had an opportunity to examine both the new tax and the relevant limitations period last week. *Law Office of John H. Eggertsen, P.C. v. Comm'r*, No. 14-2591, 2015 U.S. App. LEXIS 15930 (6th Cir. Sept. 8, 2015). While technical, the tax issue is straightforward; the limitations issue is far more interesting.

In 1998, Mr. Eggertsen bought all of the shares in J & R's Little Harvest, Inc. This corporation then filed an election to be treated as an S Corporation and changed its name to Law Office of John H. Eggertsen, P.C. (the "Law Office"). Then Mr. Eggertsen went through the steps outlined above to create an ESOP that held all of his stock in the Law Office. Eggertsen, 2015 U.S. App. LEXIS 15930, at *2-*3. After broad participation rules associated with the new excise tax went into effect,

the Law Office amended the ESOP in an effort to comply, and it moved the stock allocated to Eggertsen to a non-ESOP account in June 2005. *Id.* at *5

In 2006, the Law Office and the ESOP filed returns for 2005; the corporate return indicated that the ESOP owned all its stock, and the ESOP return reported $868,833 in assets, including $401,500 of which represented the value of the stock in the Law Office. Because the Law Office believed it had complied with the new rules, it did not file an excise tax return. *Id.*

The IRS commenced an audit in 2008, and it issued a deficiency in 2011, imposing $200,750 in excise tax on the $401,500 of Law Office stock. *Id.* at *5-*6. The Law Office filed a petition with the Tax Court, which initially held that the excise tax applied, but that the limitations period to assess it had expired. After the government moved for reconsideration, the Tax Court concluded that its prior ruling on the limitations period was wrong. *Id.* at *6.

On appeal, the Sixth Circuit first looked at the tax, which was imposed under Section 4979A of the Internal Revenue Code. There are various circumstances in which the fifty percent excise tax applies; one is where there is a “nonallocation year.” I.R.C. § 4979A(a)(3). A nonallocation year occurs when at any point during the plan year an ESOP holds employer securities issued by an S Corporation and “disqualified persons” own at least fifty percent of its stock. I.R.C. § 409(p)(3)(A). Since the Law Office acknowledged that 2005 was a “nonallocation year,” the Sixth Circuit had little difficulty concluding that the excise tax applied. *Eggertsen*, 2015 U.S. App. LEXIS 15930, at *7-*10.

The limitations period is far less cut and dried. There is an express provision in Section 4979A that applied because the tax was triggered by a nonallocation year; this provision gives the IRS three years to assess the excise tax measured from the later of the relevant violation or the date when the IRS was notified of the relevant allocation or ownership. *See* I.R.C. § 4979A(e)(2)(D). This is what the government originally argued was the controlling limitations period. After it lost under this provision, the government then persuaded the Tax Court that the general three year assessment limitation provision of Section 6501(a) applied.

The Sixth Circuit concluded that Section 6501(a) applied and that the excise tax was assessed on a timely basis. The Court first noted that the Law Office had failed to file the requisite excise tax return, which would have started the limitations period running. *Eggertsen*, 2015 U.S. App. LEXIS 15930, at *11. Next, the Court concluded that the returns filed by the Law Office and the ESOP were not sufficient to start the three year limitations period, holding that they did not provide the IRS with sufficient information to assess the excise tax as they did not reveal the extent of the stock that was subject to the tax. *Id.* at *11-*13.

The case merits further discussion, including a look at why Court did not apply the express limitation period of Section 4979A(e)(2)(D), and at the propriety of the government’s shift in position, which troubled the dissenting panel member. Consequently, another post will follow.

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