

## Nebraska Supreme Court Validates Pre-transaction Planning to Qualify for Nebraska's Special Capital Gains Exclusion

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The Nebraska Supreme Court recently issued an important, taxpayer favorable ruling in *Stewart v. Nebraska Dept. of Rev.*<sup>[1]</sup> In *Stewart*, the court ruled that the federal “economic substance” and “sham transaction” doctrines do not apply in determining whether a corporation is a qualified corporation for purposes of Nebraska’s special capital gains exclusion. This ruling effectively blesses pre-transaction planning that causes a corporation to become a qualified corporation.

### Background

Nebraska’s special capital gains exclusion was adopted in 1987 as part of the Employment and Investment Growth Act, which is commonly known as LB 775. The special gains exclusion allows a Nebraska taxpayer to make a one-time election during his or her lifetime to exclude from Nebraska income capital gains from the sale of “capital stock of a corporation acquired by the individual (a) on account of employment by such corporation or (b) while employed by such corporation,”<sup>[2]</sup> and avoid paying 6.84% Nebraska state income tax on the excluded gain.

In order for selling shareholders to qualify for the Nebraska special capital gains exclusion, the corporation must be a qualified corporation. A qualified corporation must, “at the time the first sale or exchange for which an election is made, have (i) at least five shareholders and (ii) at least two shareholders or groups of shareholders who are not related to

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each other and each of which owns at least ten percent of the capital stock.”<sup>[3]</sup>

Family- and closely-held corporations are often not qualified corporations. In an effort to become a qualified corporation, some of these corporations and their shareholders, while negotiating a sale or even after signing an agreement to sell their capital stock, have facilitated pre-transaction stock transfers that cause the corporation to satisfy the literal terms of the qualified corporation definition. Prior to *Stewart*, there was substantial uncertainty regarding this pre-transaction planning. Starting around 2008, the Nebraska Department of Revenue took the position that these types of pre-transaction actions would be ignored if they did not have “economic substance.”

### Summary of Stewart Case

In *Stewart*, the shareholders of a target corporation signed a purchase agreement to sell their target corporation stock on February 26, 2010. At that time, the target corporation was not a qualified corporation because it had only three shareholders. After the purchase agreement was signed, a shareholder of the target corporation entered into separate agreements with three officers of the purchaser to sell each of the officers one share of target corporation stock. The officers purchased these shares with non-recourse notes which were due at closing and secured by a first lien on the stock. The officers also agreed to sell the acquired stock pursuant to the purchase agreement. These transactions caused the target corporation to have six shareholders and satisfy the literal terms of element (i) of the qualified corporation definition. On March 1, 2010, the transaction closed and the shareholders of the target corporation (including the three long-term shareholders and three new shareholders) sold 100% of the target corporation's outstanding stock to the purchaser.

Two married target corporation shareholders filed a joint return for 2010 and elected to take the Nebraska special capital gains exclusion on their March 1, 2010 stock sale (but not the February 26, 2010 planning sales of three shares). The Nebraska Department of Revenue disallowed the exclusion on the grounds that the target corporation was not a qualified corporation and issued a \$499,732 tax deficiency plus additional penalties and interest. The Tax Commissioner sided with the Department and concluded that the target corporation was not a qualified corporation because it only had three shareholders at the time of the sale. The Tax Commissioner disregarded the sales of stock to the three officers by applying the federal common law “economic substance” and “sham transaction” doctrines. The district court for Lancaster County affirmed the Tax Commissioner's order.

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On appeal, the Nebraska Supreme Court reversed the district court and found “no support in the plain language of either [applicable] statute to review transactions that come before the ‘first sale or exchange for which the election is made’ for a special capital gains” exclusion.<sup>[4]</sup> Because the plain language of the qualified corporation definitional statute was found to be clear and unambiguous, the Nebraska Supreme Court determined that the federal common law “economic substance” and “sham transaction” doctrines do not apply. Accordingly, the target corporation was a qualified corporation as of March 1, 2010 - the date of the first sale for which the taxpayers elected to take the Nebraska special capital gains exclusion - and the taxpayers were entitled to exclude the capital gain on their March 1, 2010 stock sale from Nebraska income.

### Conclusion

The *Stewart* case makes clear that if a corporation meets the literal terms of the qualified corporation definition as of the date of the first sale or exchange for which the Nebraska special capital gains exclusion is taken, the corporation will be respected as a qualified corporation. The federal “economic substance” and “sham transaction” doctrines do not apply to disregard pre-transaction planning that causes the corporation to become a qualified corporation. This ruling may allow Nebraska owners of family- and closely-owned corporations who are selling their stock to engage in Nebraska special capital gains exclusion planning on the eve of closing, and, by doing so, avoid paying 6.84% Nebraska state income tax on the properly excluded capital gain. Please contact one of the authors or your regular Koley Jessen contact with any questions.

<sup>[1]</sup> 294 Neb. 1010 (2016).

<sup>[2]</sup> Neb. Rev. Stat. § 77-2715.09(1).

<sup>[3]</sup> Neb. Rev. Stat. § 77-2715.08(2)(c).

<sup>[4]</sup> *Stewart*, 294 Neb. at 1017.

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