Snap-Drape, Inc. v. Commissioner, 105 T. C. 16, 1995 U. S. Tax Ct. LEXIS 38, 105 T. C. No. 2, 19 Employee Benefits Cas. (BNA) 1592 (1995)

The court upheld the validity of a Treasury regulation disallowing deductions for dividends paid to an ESOP under section 404(k) for purposes of computing adjusted current earnings (ACE) for alternative minimum tax (AMT), and found no abuse of discretion in its retroactive application.

Summary

Snap-Drape, Inc. established an ESOP and paid dividends to it, which were used to service debt incurred for acquiring company stock. The company claimed these dividends as deductions under section 404(k) but did not include them in computing its ACE for AMT. The Commissioner disallowed the deduction, citing a Treasury regulation. The Tax Court upheld the regulation's validity, finding it consistent with the statutory purpose of ensuring fair tax contributions. The court also found that the retroactive application of the regulation did not constitute an abuse of discretion, emphasizing that the regulation did not alter settled law and that the company had not shown undue reliance or harsh consequences from the regulation.

Facts

Snap-Drape, Inc. established an Employee Stock Ownership Plan (ESOP) in 1990. The ESOP borrowed $5 million to buy 80% of the company's stock from its founders, with the loan guaranteed by the company. In 1990, Snap-Drape made contributions to the ESOP and paid it $1. 44 million in dividends, which were used to pay off the loan. The company claimed deductions for both the contributions and the dividends on its 1990 tax return but did not include the dividends in calculating its Adjusted Current Earnings (ACE) for the Alternative Minimum Tax (AMT). The Commissioner disallowed the deduction for dividends under a regulation that excluded section 404(k) dividends from ACE computations.

Procedural History

The Commissioner determined a deficiency in Snap-Drape's 1990 federal income tax, leading to a dispute over the validity and retroactive application of the regulation disallowing section 404(k) dividends in computing ACE for AMT. The case was heard by the United States Tax Court, which upheld the regulation and its retroactive application.

Issue(s)

1. Whether dividends paid to an ESOP under section 404(k) are deductible in computing the adjusted current earnings of a corporation for purposes of determining alternative minimum tax.
2. Whether the Commissioner abused her discretion by providing retroactive application of the regulation disallowing such deductions.

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Holding

1. No, because the regulation disallowing section 404(k) dividends for computing ACE is valid and consistent with the statutory purpose of the AMT regime.
2. No, because the retroactive application of the regulation was not an abuse of discretion, as the regulation did not alter settled law and the taxpayer did not show undue reliance or harsh consequences.

Court's Reasoning

The court found that the regulation was a legislative regulation, issued under a specific congressional grant of authority, and deserved deference. It argued that section 404(k) dividends, though deductible under regular tax rules, are not deductible in computing earnings and profits, and thus, under the AMT regime, they should not be deductible in computing ACE. The court emphasized the AMT's purpose of ensuring that corporations pay a fair share of tax despite tax preferences. It rejected Snap-Drape's arguments that the dividends should be treated as compensation or that they reduced earnings and profits for accounting purposes. The court also held that the retroactive application of the regulation was not an abuse of discretion, as the taxpayer could not show reliance on settled law or demonstrate that the regulation's application resulted in inordinately harsh consequences.

Practical Implications

This decision clarifies that dividends paid to an ESOP under section 404(k) are not deductible in computing ACE for AMT, affecting how corporations with ESOPs calculate their tax liabilities. It reinforces the importance of considering the AMT when structuring ESOP transactions and planning for tax deductions. The ruling also sets a precedent for the validity of Treasury regulations and their retroactive application, emphasizing that such regulations must align with statutory purposes and that taxpayers must demonstrate reliance on settled law to challenge retroactivity. Future cases involving tax regulations and their retroactive application will likely cite this case, particularly in contexts where the AMT and corporate tax deductions are at issue.

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