

Part III - Administrative, Procedural, and Miscellaneous

S Corporation Tax Shelter

Notice 2004-30

The Internal Revenue Service and the Treasury Department are aware of a type of transaction, described below, in which S corporation shareholders attempt to transfer the incidence of taxation on S corporation income by purportedly donating S corporation nonvoting stock to an exempt organization, while retaining the economic benefits associated with that stock. This notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, and substantially similar transactions, as listed transactions for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations. This notice also alerts parties involved with these transactions to certain responsibilities that may arise from their involvement with these transactions.

FACTS

In a typical transaction, an S corporation, its shareholders, and an organization exempt from tax under § 501(a) and described in either § 501(c)(3) or § 401(a) of the Internal Revenue Code (such as a tax-qualified retirement plan maintained by a state or local government) (the exempt party) undertake the following steps. An S corporation issues, pro rata to each of its shareholders (the original shareholders), nonvoting stock and warrants that are exercisable into nonvoting stock. For example, the S corporation issues nonvoting stock in a ratio of 9 shares for every share of voting stock and warrants in a ratio of 10 warrants for every share of nonvoting stock. Thus, if the S corporation has 1,000 shares of voting stock outstanding, the S corporation would issue 9,000 shares of nonvoting stock and warrants exercisable into 90,000 shares of nonvoting stock to the original shareholders. The warrants may be exercised at any time over a period of years. The strike price on the warrants is set at a price that is at least equal to 90 percent of the purported fair market value of the newly issued nonvoting stock on the date the warrants are granted. For this purpose, the fair market value of the nonvoting stock is claimed to be substantially reduced because of the existence of the warrants.

Shortly after the issuance of the nonvoting stock and the warrants, the original shareholders donate the nonvoting stock to the exempt party. The parties to the transaction claim that, after the donation of the nonvoting stock, the exempt party owns 90 percent of the stock of the S corporation. The parties further claim that any taxable

income allocated on the nonvoting stock to the exempt party is not subject to tax on unrelated business income (UBIT) under §§ 511 through 514 (or the exempt party has offsetting UBIT net operating losses). The original shareholders might also claim a charitable contribution deduction under § 170 for the donation of the nonvoting stock to the exempt party. In some variations of this transaction, the S corporation may issue nonvoting stock directly to the exempt party.

Pursuant to one or more agreements (typically redemption agreements, rights of first refusal, put agreements, or pledge agreements) entered into as part of the transaction, the exempt party can require the S corporation or the original shareholders to purchase the exempt party's nonvoting stock for an amount equal to the fair market value of the stock as of the date the shares are presented for repurchase. In some cases, the S corporation or the original shareholders guarantee that the exempt party will receive the fair market value of the nonvoting stock as of the date the stock was given to the exempt party if that amount is greater than the fair market value on the repurchase date.

Because they own 100 percent of the voting stock of the S corporation, the original shareholders have the power to determine the amount and timing of any distributions made with respect to the voting and nonvoting stock. The original shareholders exercise that power to cause the S corporation to limit or suspend distributions to its shareholders while the exempt party purportedly owns the nonvoting stock. For tax purposes, however, during that period, 90 percent of the S corporation's income is allocated to the exempt party and 10 percent of the S corporation's income is allocated to the original shareholders. The transaction is structured for the original shareholders to exercise the warrants and dilute the shares of nonvoting stock held by the exempt party, or for the S corporation or the original shareholders to purchase the nonvoting stock from the exempt party at a value that is substantially reduced by reason of the existence of the warrants. In either event, the exempt party will receive a share of the total economic benefit of stock ownership that is substantially lower than the share of the S corporation income allocated to the exempt party.

DISCUSSION

The transaction described in this notice is designed to artificially shift the incidence of taxation on S corporation income away from taxable shareholders to the exempt party. In this manner, the original shareholders attempt to avoid paying income tax on most of the S corporation's income over a period of time.

The Service intends to challenge the purported tax benefits from this transaction based on the application of various theories, including judicial doctrines such as substance over form. Under appropriate facts and circumstances, the Service also may argue that the existence of the warrants results in a violation of the single class of stock

requirement of § 1361(b)(1)(D), thus terminating the corporation's status as an S corporation. See, e.g., §§ 1.1361-1(l)(4)(ii) and (iii).

Transactions that are the same as, or substantially similar to, the transaction described in this notice are identified as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2) effective April 1, 2004, the date this notice was released to the public. Independent of their classification as listed transactions, transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the disclosure requirements of § 6011 (§ 1.6011-4), the tax shelter registration requirements of § 6111 (§ 301.6111-1T and § 301.6111-2), or the list maintenance requirements of § 6112 (§ 301.6112-1). Under the authority of § 1.6011-4(c)(3)(i)(A), the exempt party in the listed transaction described in this notice will also be treated as a participant in the transaction (whether or not otherwise a participant). The exempt party will be treated as participating in the transaction for the taxable year of the purported donation, the taxable year of the reacquisition, and all intervening taxable years. Pending further review and possible additional guidance, this notice does not apply to any investment in employer securities, as defined in § 409(l), by an employee stock ownership plan subject to the requirements of § 409(p).

Persons who are required to register these tax shelters under § 6111 but have failed to do so may be subject to the penalty under § 6707(a). Persons who are required to maintain lists of investors under § 6112 but have failed to do so (or who fail to provide those lists when requested by the Service) may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under § 6662.

The Service and the Treasury Department recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this notice. These taxpayers should take appropriate corrective action and ensure that their transactions are disclosed properly.

The principal author of this notice is Tara P. Volungis of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice contact Ms. Volungis at (202) 622-3070 (not a toll-free call).