APPEALS
SETTLEMENT GUIDELINES

INDUSTRY: S Corporations (All Industries)

ISSUE: S Corporation Shareholders Attempt to Transfer the Incidence of Taxation on S Corporation Income by Donating S Corporation Stock to a Tax Exempt Organization While Retaining the Economic Benefits Associated with the Stock (Notice 2004-30)

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APPROVED:

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EFFECTIVE DATE: April 20, 2007

APPEALS SETTLEMENT GUIDELINES
NOTICE 2004-30
UIL No. 9300.36-00

Statement of Issues

Issue 1:

Whether the transfer of the S corporation stock to the exempt party in a transaction described in Notice 2004-30 will be disregarded for federal tax purposes under judicial doctrines. Consequently, if disregarded, the S corporation and original shareholders entering into transactions that are the same as or substantially similar to those described in Notice 2004-30, shall be treated as if there had been no transfer to the exempt party.

Issue 2:

Alternatively, whether the capital structure created in the Notice 2004-30 transaction violates the single class of stock requirement of § 1361(b)(1)(D) of the Internal Revenue Code[1] (hereinafter "IRC") and § 1.1361-1(l) of the Income Tax Regulations. If a violation occurred, the S corporation election will terminate on the date the second class of stock was issued and the corporation will be treated as a C corporation. Thus, the income will not be allocated to the shareholders and the income will be taxable to the C corporation.

Issue 3:

Whether the transfer of nonvoting stock to the exempt party qualifies as a deductible charitable contribution pursuant to IRC § 170.

Issue 4:

Whether the transaction costs incurred in connection with the Notice 2004-30 transactions, including promoter's fees, accounting fees, legal fees, appraisal fees, and redemption payments recharacterized as accommodation fees, are deductible under IRC §§ 162, 165, or 212.

Issue 5:

Whether the accuracy-related penalty under IRC § 6662 for negligence or disregard of rules or regulations and/or a substantial understatement of income

[1] All references are to the Internal Revenue Code of 1986, as amended.

tax should be asserted for taxpayers who engaged in Notice 2004-30 transactions.

Background

Notice 2004-30[2] issued on April 1, 2004, announced that the Service will challenge transactions 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 party while retaining the economic benefits associated with that stock.

Notice 2004-30 was designated by the Service as a "Listed Transaction"[3] on April 26, 2004. Subsequently, Appeals Technical Guidance designated the Notice 2004-30 transaction as an Appeals Coordinated Issue (hereinafter "ACI") on July 19, 2004. The Government issued its Coordinated Issue Paper (hereinafter "CIP")[4] on November 8, 2004.

Facts

The Typical Transaction

A typical transaction involves an S corporation, its shareholders, and a tax exempt organization (the exempt party). The exempt party is exempt from tax under IRC § 501(a) and is described in either IRC § 501(c)(3) or § 401(a) (such as a tax-qualified retirement plan maintained by a state or local Government), and is an organization eligible to receive charitable contributions as defined by IRC § 170(c).

The parties undertake the following steps. An S corporation issues, pro rata to each of its shareholders (the original shareholders), nonvoting stock and warrants which 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, it 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.

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[2] 2004-17 I.R.B. 828

[3] Listed transactions are transactions that have been identified by the IRS as tax avoidance transactions for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and § 301.6112-1(b)(2) of the Procedure and Administration Regulations. Listed transactions are identified in Notice 2004-67, 2004-41 I.R.B. 600, and on Compliance's LMSB web site at http://lmsb.irs.gov/hq/pftg/otsa/listedtransactions.htm.

[4] See IRM § 8.7.3.11

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 transfer the nonvoting stock to the exempt party. The S corporation and its shareholders contend that, after the transfer of the nonvoting stock, the exempt party owns 90 percent of the stock of the S corporation. Any taxable income allocated to the exempt party shareholder is claimed not to be subject to tax on unrelated business income under IRC §§ 511 through 514 (or the exempt party has offsetting unrelated business net operating losses). The original shareholders claim a charitable contribution deduction under IRC § 170 for the transfer of the nonvoting stock to the exempt party. In some variations of this transaction, the S corporation may issue the nonvoting stock directly to the exempt party and the charitable contribution would flow through to the shareholders.

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 pledge that the exempt party will receive the fair market value of the nonvoting stock as of either the transfer date or the repurchase date, whichever amount is greater.

Because the original shareholders own 100 percent of the voting stock of the S corporation, those 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 limit or suspend distributions, 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 typically is structured either 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 an economic benefit that is a mere fraction of the income allocated to the exempt party.

As previously noted, in some instances, the transfer of nonvoting stock was made by the S corporation instead of the shareholders. Also, in some cases, the pledge agreements may have been executed by the S corporation instead of the

shareholders. In some cases, the assets of the S corporation may have been sold while the exempt party held the nonvoting stock, typically with ninety percent of the gain from the sale allocated to the exempt party.

Generally, the exempt parties take no steps to record the transfer of the stock or any aspect of the transaction on their books and do not list the nonvoting shares as assets in their financial reports. Typically, the exempt parties only record the transactions when they receive cash payments under the redemption agreements or other purchase agreements. Typically, the S corporations do not send Schedules K-1, "Shareholder's Shares of Income, Credits, Deductions, etc.," to the exempt party.

The S corporation and the original shareholders involved in a Notice 2004-30 transaction typically incur transaction costs, including promoter's fees, accounting fees, and legal fees. There may also be additional "out of pocket" costs for entering into the transaction.

Law & Argument

Issue 1:

Government's Position

The essence of this transaction is not a donative contribution of stock to an exempt party. Instead, the primary purpose of the transaction is to reduce the S corporation's pass-through income to the original shareholder's personal tax returns by approximately 90 percent while leaving that income in the S corporation so the economic benefits of owning the stock would be enjoyed at a later date by the original shareholders.

Taxpayers' Position[5]

Taxpayers argue this is a legitimate transaction, similar to Palmer v. Commissioner, 62 T.C. 684 (1974), which involved a charitable contribution, followed by a redemption of stock. Taxpayers further argue that contributions do not require a non-tax reason and the economic substance test is not necessarily appropriate. The nonvoting stock transferred gave beneficial ownership to the exempt parties. Thus, this transfer should be respected for Federal income tax purposes.

[5] Appeals received responses from multiple taxpayers with respect to the issues set forth in the Government's CIP. Therefore, the taxpayers' position will reflect all the viewpoints that were submitted. However, the responses were submitted prior to the Senate Subcommittee's report dated February 8, 2005.

Discussion[6]

A. Government's Analysis

The Government argues that the transfer of the S corporation stock to the exempt party will be disregarded for Federal tax purposes under judicial doctrines. Various judicial doctrines may be applicable to Notice 2004-30 transactions. The arguments have been classified under the general doctrines of substance over form and economic substance. Note that some courts may categorize the doctrines in a different manner.

1. Substance Over Form Doctrines

It is axiomatic that the substance rather than the form of a transaction governs the Federal income tax treatment of the transaction. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering , 293 U.S. 465 (1935). Substance over form and related judicial doctrines all require "a searching analysis of the facts to see whether the true substance of the transaction is different from its form or whether the form reflects what actually happened." Harris v. Commissioner, 61 T.C. 770, 783 (1974). The issue of whether any of those doctrines should be applied involves an intensely factual inquiry. See Gordon v. Commissioner, 85 T.C. 309 (1985).

Transactions that literally comply with the language of the Code but produce results other than what the Code and regulations intend are not given effect. In Gregory v. Helvering, 293 U.S. 465, 470 (1935), the Supreme Court found that even though the transaction did comply with the Code, "The transaction upon its face lies outside the plain intent of the statute." Therefore, the Court found that to give the transaction effect would be to "exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Id. In Knetsch v. United States, 364 U.S. 361 (1960), the Supreme Court once again found a transaction abusive, even though the transaction met every literal requirement of the Code. The Court stated that "there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction." Id. at 366.

Even if it is found that the Notice 2004-30 transaction literally complies with the Code and regulations, this abusive transaction produces results other than what the Code and regulations intended. It was never intended that S corporation income could be allocated to an exempt party to avoid income tax while the original shareholders retained the economic benefit of the income. While the form of this transaction suggests that the exempt party is a shareholder of the S corporation, the exempt party does not bear a risk, commensurate with its purported stock ownership, that the stock may decline in value, nor does the

[6] This tax shelter transaction involves three parties and eight steps. The reader is directed to the end of this ASG for a diagram and its corresponding steps of this transaction on pages 45 and 46.

exempt party enjoy a benefit, commensurate with its purported stock ownership, if the stock increases in value. There is nothing of substance to be realized in this abusive transaction aside from substantial tax savings at the original shareholder level.

A transaction that is entered into solely for the purpose of tax reduction and that has no economic or commercial objective to support the transaction is a sham and is without effect for federal income tax purposes. Estate of Franklin v. Commissioner, 64 T.C. 752 (1975); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985); Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Nicole Rose Corp. v. Commissioner, 117 T.C. 328 (2001); see Dow Chemical Co. v. United States, 435 F.3d 594, (6th Cir. 2006). When a transaction is treated as a sham, the form of the transaction is disregarded and the proper tax treatment of the transaction must be determined.

Other than the allocation of income, the parties did not treat the exempt party as owning 90 percent of the S corporation. For example, in most of the Notice 2004-30 transactions, the exempt party failed to record the nonvoting stock as an asset of the plan. A number of the S corporations did not send Schedules K-1 to the exempt party. Because the Notice 2004-30 transaction is a sham, the form of the transaction should be disregarded and the original shareholders generally should be treated as owning all of the S corporation stock.

Rev. Rul. 70-615, 1970-2 C.B. 169, provides that a taxpayer who is the record holder of a small business corporation's stock, but who has no beneficial interest in it, is not considered the shareholder. See also Pacific Coast Music Jobbers v. Commissioner, 55 T.C. 866 (1971), aff'd 457 F.2d 1165 (5th Cir. 1972) (in determining whether a sale had occurred, the Court considered not only when the bare legal title passed but also when the benefits and burdens of the property, or the incidents of ownership, were acquired or disposed of).

In this instance, the transferor merely parked the stock with the exempt party during the holding period. The abusive aspects of the transaction allow the original shareholders to allocate 90 percent of the S corporation's income to the exempt party while preventing the exempt party from participating in the benefits and burdens of stock ownership to the degree commensurate with the exempt party's purported stock ownership. Because the exempt party appears to be simply a facilitator without beneficial ownership of the S corporation stock, the exempt party generally should not be treated as a shareholder for purposes of the allocation of income. Further, any amount received by the exempt party upon exercise of its put right under the redemption agreement should be viewed as a payment for the performance of services as an accommodation party. However, if the exempt party were considered to be a shareholder rather than a mere facilitator or accommodation party, the exempt party would be treated as a shareholder only to the extent of the actual economic benefits it realizes from holding the stock.

2. Economic Substance Doctrines

A transaction must have economic substance separate and distinct from the economic benefit achieved solely from tax reduction. If a taxpayer seeks to claim tax benefits that were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. United States v. Wexler, 31 F.3d 117, 122, 124 (3d Cir. 1994); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), aff'g 44 T.C. 284 (1965); ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part, 157 F.3d 231 (3d Cir. 1998); Dow Chemical Co. v. United States, 435 F.3d 594, (6th Cir. 2006).

Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950). The determination turns on whether the transaction is rationally related to a useful non-tax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated non-tax purpose and the rationality of the means chosen to effectuate that purpose must be evaluated in accordance with relevant practices. Cherin v. Commissioner, 89 T.C. 986, 993-94 (1987); ACM Partnership, 157 F.3d at 248-49. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the non-tax benefits would be at least commensurate with the transaction costs. Yosha, at 502; ACM Partnership, at 249-50.

The Notice 2004-30 transaction had no economic substance outside of the tax savings to the original shareholders and serves no non-tax purpose of either the S corporation or the original shareholders. The restructuring of the S corporation and the issuance and purported transfer of the nonvoting stock has no non-tax purpose. The result of the transaction is that the original shareholders park the S corporation stock with the exempt party for a period of time while the S corporation makes little or no distributions. The transaction costs far outweigh any possible non-tax purpose. The overall effect of these transactions achieves a result that is clearly inconsistent with Congressional intent for Subchapter S. The exempt party does not possess meaningful benefits and burdens of stock ownership because the exempt party is not impacted by increases or decreases in the value of the stock commensurate with its purported ownership interest in the S corporation. The exempt party does not treat the transaction as a transfer of the nonvoting S corporation stock on its books and does not list the shares as assets. The original shareholders are the true owners. The exempt party takes on the appearance of an S corporation shareholder during the period it holds the nonvoting stock, only to have the interest revert to the original shareholders upon subsequent planned actions. Even if the exempt party were considered a shareholder rather than merely taking on the appearance of a shareholder, at most it would be treated as a shareholder to the extent of the actual economic

benefits it realizes from holding the stock. The only economic substance of the transaction is the tax savings to the original shareholders. Even if the transaction complies with the literal language of the Code, it has no economic substance separate from the tax benefits and should not be respected.

Other judicial doctrines, such as economic compulsion, step transaction or business purpose may apply to Notice 2004-30 transactions. If you have questions concerning the application of these doctrines please contact the S Corporation Technical Guidance Coordinator.[7]

B. Taxpayers' Analysis

The taxpayer argues that the key issue is not whether the taxpayer reasonably expects to generate a pre-tax profit. The proposed transaction is entirely distinguishable from this line of analysis because the shareholder is making a philanthropic gesture through his charitable contribution. Charitable contributions have never been questioned for their pre-tax profit motive because there is not a pre-tax profit motive and there could never be one. The gift is considered charitable because the taxpayer is giving something of value to a charitable organization, without receiving anything in return. By its very nature, a charitable contribution donation could not require a pre-tax motive, otherwise, all charitable gifts would fail the economic substance test. If any charitable contribution is to be respected for income tax purposes, the economic substance must be measured by whether the transaction changes the economic interests of the parties. In other words, a charitable contribution has economic substance when the donor has parted with, and the donee has received, something of value.

It appears that the transaction involves a transfer of something of value so that the transaction has economic substance. The taxpayer presents several responses to the IRS' possible contention that the transfer of 90% of the S corporation stock to the exempt party lacks economic substance because the effect of the warrants is to ensure that no more than 11.25% of the economic value of the equity of the S corporation is shifted to the exempt party.

One response is that it is common for closely-held corporations that issue stock to key employees who are not the "founders" of the corporation to require that those "non-founding" shareholders enter into buy/sell or redemption agreements that do not apply to the stock of the "founding" shareholders. In such situations, there is no authority to support treating the "non-founding" shareholders as beneficially owning less than their actual amount of stock simply because their stock could be redeemed at a lower price per share than that of the "founding" shareholders. In fact, Treas. Reg. § 1.1361-1(l)(2)(v), Example 9, contains exactly that fact pattern. The example concludes that the terms of the

[7] Appeals is unaware that any of these judicial doctrines have been raised. Therefore, this ASG will not address these issues. If a case is received with one or more of these issues, please contact the Appeals' Technical Guidance Coordinator.

redemption agreement are disregarded in determining whether the S corporation has a second class of stock unless a principal purpose of the redemption agreement is to circumvent the IRC § 1361(b)(1)(D) one class of stock requirement. In this transaction no principal purpose of avoidance exists.

The redemption agreement here is analogous to the "non-founder" buy/sell or redemption agreement approved in Treas. Reg. § 1.1361-1(l)(2)(v), example 9. As a result, the fact that the redemption agreement applies only to the exempt party and results in capping the economic value of the exempt party 's stock should not cause the service to characterize the stock donation as lacking in economic substance.

It is also important to note that the transfer of 90% of the S corporation's stock to the exempt party not only means that 90% of income and gains are allocable to the exempt party, but, in the event that the S corporation incurs losses, the tax benefit of 90% of those losses would be allocated to the exempt party. Accordingly, the 90% allocation has the potential for tax detriment as well as benefit.

Moreover, any income or gains of the S corporation allocable to the exempt party while it is a shareholder, will increase the tax basis of the exempt party‘s S corporation stock. The shareholder will obtain no stock basis increase for the income or gain allocable to the exempt party. When all the tax consequences of the overall transaction are taken into consideration, there is not an excessive tax benefit to the shareholder when compared to the economic cost of the transaction.

The change in the law in IRC § 1361(c)(6) and § 1361(b)(1)(B) specifically authorized and approved the transfer of stock of an S corporation to an exempt party in taxable years beginning after 12/31/96. In this type of transaction, it is expected the exempt party will redeem after a period of time.

Based on the factors below it appears that the shareholder has transferred beneficial ownership of the full 90% of the outstanding stock of the S corporation and the transfer should be respected.

1. Whether the exempt party is able to effectively exercise ownership rights of its shares. Under the facts, the exempt party is an independent party not under the control of the shareholder and is able to fully exercise all of its rights as a shareholder.

2. Whether the shareholder continued to exercise complete dominion and control over the transferred stock. Under the facts, the exempt party has not waived any of its rights as a shareholder. It is entitled to notice of shareholder meetings and has the right to attend those meetings. It has the same rights as

other shareholders to inspect corporate books and records. There is no retention by the shareholder of any dominion or control over the transferred stock.

3. Whether the shareholder continued to enjoy economic benefits of ownership after conveyance of the stock. This is a potential weak point if no dividends are paid during the period of time that the exempt party owns the stock. As noted above, the absence of dividend payments while the corporation enjoyed substantial earnings has been viewed as evidence of the transferor's retention of the economic benefit.

However, the exempt party knew when it accepted the gift that it was for nonvoting stock which did not have the power to force the corporation to make distributions. Therefore, it should not be relevant whether distributions were actually made because the exempt party knew when it accepted the stock that it did not have the power to force a distribution.

It should also be noted that a corporation is not required to pay dividends or make distributions under tax or state law. In Lawton v. Commissioner, 164 F.2d 380 (6th Cir. 1947), the court analyzed whether a transfer of stock from a father to his children should be respected. The Service pointed out the fact that distributions were never made. However, the Sixth Circuit ruled that the reinvestment of non-excessive profits by a corporation was not unwarranted or even unusual. Therefore, to the extent that the S corporation needs the funds for business reasons, the failure to make distributions should not be relevant to the analysis of whether the exempt party is the beneficial owner of the nonvoting stock.

With respect to the S corporation specifically, one court has held that where the individual shareholders are taxed on the retained earnings of the corporation, it is not necessarily oppressive of the corporation to fail to distribute earnings. See Iwasaki v. Iwasaki Bros., Inc., 649 P.2d 598. If a shareholder believes that the corporation is improperly withholding legitimate distributions, it has the right to file suit and compel the corporation to make a distribution. The exempt party in this transaction has that right.

4. Whether the shareholder dealt at arm's length with the S corporation in order to meet this factor. Any post-transfer transactions between the shareholder and the S corporation that could confer an economic benefit on the shareholder should be avoided.

5. Whether the exempt party has full, independently exercisable voting rights in the stock. Since the stock to be transferred to the exempt party is nonvoting, this factor doesn't appear to be relevant.

6. Whether the exempt party will have the right to receive all of the dividends payable on the stock. Typically, the exempt party has exactly the same rights to dividends, to the extent that any are declared, as does the shareholder.

7. Whether the exempt party is entitled to sell, dispose of, or encumber such stock at its sole discretion without the approval of the S corporation. Typically, except for the restriction against any transfer of its stock that would cause the corporation's S election to be terminated, the exempt party's stock is freely alienable without the approval of any other party.

8. Whether the exempt party has the right to receive the proceeds of any liquidating distribution. In the event of the liquidation of the S corporation while the exempt party is a shareholder, its stock has the same per share right to liquidation proceeds as the stock of the shareholder.

9. Whether the exempt party has the right to participate in management. Typically, the exempt party has no right to participate in management. However, as a shareholder, it has full rights to attend and participate (except for voting) in shareholder meetings and will have access to the S corporation's books and records.

10. Whether the exempt party's stock will economically participate in future business activities of the S corporation. Typically, there is no arrangement in effect, nor is any contemplated, that would have the effect of preventing the shares of stock owned by the exempt party from participating in any future business activities of the S corporation.

Based on the above analysis, it appears that the shareholder would be found to have transferred beneficial ownership of 90% of the outstanding stock to the exempt party. Therefore, such transfer should be respected for federal income tax purposes.

Another argument the Service can raise is that there is no business purpose for the distribution of nonvoting stock and warrants. For example, the Service could argue that the shareholder could have achieved the same economic result by distributing one share of nonvoting stock as opposed to distributing 900 shares, diluted by warrants.

IRC § 301, which governs the tax treatment of corporate distributions, is very broad in specifying the types of permissible corporate distributions. By its terms, the statute does not contain any business purpose requirement. It also does not appear that there is any case law imposing a business purpose for corporate distributions, except when the distributions form a part of a corporate organization or reorganization. With regard to distributions of stock specifically, the applicable provision, IRC § 305, also does not contain any business purpose

requirement. As such, it appears that corporations are permitted to structure distributions in any manner they see fit.

In the event the service is successful in imposing a business purpose requirement for the distributions, there are several business purposes for the issuance of nonvoting common stock and warrants. For example, the warrants could be used for estate planning and gifting such as a contribution to a Family Limited Partnership, a contribution to a charitable remainder unitrust, and other charitable bailouts, such as pooled income funds to allow for future diversification. Additionally, the warrants could also be used for financing or obtaining liquidity with ineligible S corporation shareholders such as public companies, venture/private equity funds, and capital for transactions with other companies, e.g. mergers or acquisitions. The warrants could also be sold to an ineligible shareholder (by the existing shareholder) who could then exercise them, if desired. To the extent that the issuance of the warrants accomplishes family financial planning objectives, the likelihood of the warrant issuance being attacked for lack of business purpose diminishes.

C. Appeals' Analysis

Taxpayers cite Palmer v. Commissioner, 62 T.C. 684 (1974), in support of their argument that there was a transfer of nonvoting stock to the exempt party. However, the issue in Palmer was what the taxpayer transferred, not whether there was a transfer. Consequently, Palmer does not support the taxpayer's argument.

In Palmer, an individual taxpayer owned about 30 percent of the shares of a corporation. The remainder of the outstanding stock was owned by a trust of which the taxpayer was both trustee and income beneficiary. During the course of one day, a charitable foundation, of which the taxpayer was the controlling trustee, purchased the shares owned by the trust and received a charitable donation from the taxpayer of enough additional shares in the corporation so that the foundation owned 80 percent of the outstanding shares. On the following day, the foundation, as shareholder, voted for a redemption of the stock in exchange for certain assets of the corporation. The redemption was carried out later that day. The Commissioner argued that the form of the transaction did not conform to its substance and determined the proper ordering of the events should have reflected a redemption of shares from the taxpayer followed by a charitable donation to the foundation of the assets received in the redemption. The Tax Court concluded the gift of stock to the foundation should be recognized because there was a transfer of ownership of the stock to the foundation, the foundation was not a sham, and the foundation was not under an obligation to have the stock redeemed. See also Rev. Rul. 78-197, 1978-1 C.B. 83.

In Palmer, the issue was whether stock or the proceeds of redemption were transferred. The taxpayer in Palmer intended to make a charitable contribution

but wanted to make the contribution in the manner that would be most beneficial to him. He did not want to realize the gain on the appreciation of the asset he wished to give to the charitable foundation. The facts in a Notice 2004-30 transaction are completely different. In a Notice 2004-30 transaction, the taxpayer has no intent to make a charitable contribution of an appreciated asset (or any asset) to the exempt party. Rather, the taxpayer purchases the exempt party's tax exempt status for a period of time in order to avoid gain on income that the taxpayer will earn in the future. There is no donative intent; there is merely the payment to the exempt party for its accommodation in carrying out the tax avoidance transaction. In substance, nothing is transferred to the exempt party other than payment for services. Consequently, the transaction, as a whole, should be disregarded. The analysis in Palmer is not applicable to Notice 2004-30 transactions and, therefore, does not support taxpayers' case.

The Notice 2004-30 transaction bears more resemblance to the transaction at issue in Ford v. Commissioner, T.C. Memo. 1983-556. In Ford, a limited partnership had a substantial amount of income from the discharge of indebtedness without the receipt of cash or other property with which to pay the resulting tax. The partners needed a large deduction to offset this income. The limited partnership created a corporation, transferred its sole asset (an underwater research vessel) to the corporation, and then contributed the corporation's stock to a state university. If the limited partnership had contributed the vessel directly to the university, its charitable contribution would have been zero. The Tax Court found that the partnership's use of the corporation was a sham to avoid the payment of tax and that the substance of the transaction was a gift of the vessel to the university.

Similar to Ford, the use of the exempt parties' tax exempt status to shelter income in a Notice 2004-30 transaction is a sham to avoid the payment of tax and should not be respected. The court in Ford distinguished the facts in that case from Palmer, explaining that the issue in Palmer was the proper ordering of events (whether redemption preceded donation) and that the Commissioner did not allege either the charitable foundation or the corporation whose stock was donated should be disregarded for lack of substance.

The cases cited in the Government's argument provide a strong basis on which the Notice 2004-30 transactions should be disregarded. There also are other cases involving alleged charitable contributions in which the judicial doctrines of substance over form and economic substance have been applied. Some of these cases are described below.

In Mount Mercy Associates v. Commissioner, T.C. Memo. 1994-83, affd. 50 F.3d 2 (2nd Cir. 1995), the court determined that the charitable contribution lacked economic substance and the partnership was not entitled to claim charitable contribution deductions for the donation of property to a religious order. The partnership contracted to purchase from the religious order unimproved land and

a parcel of land upon which a convent was located with the understanding that the partnership was to deed the convent back to the religious order. Following the purchase, the partnership took control of the unimproved land, leased the convent back to the religious order, and, eventually, transferred it back to the religious order. This transfer and reconveyance of the convent property lacked economic substance. The transaction was structured in such a way that the religious order never lost possession, control, or ownership of the convent property, as evidenced by the fact that the mortgage note secured by the convent property was never paid. In essence, the partnership purchased only the unimproved land. Therefore, no charitable deduction was allowed.

In Torney v. Commissioner, T.C. Memo. 1993-385, the court determined that the charitable contribution lacked economic substance. In making this determination the court looked to the substance of the transaction and whether what was done, apart from the tax motive, was that which the statute intended. In the final analysis, the court determined that the stocks involved therein were never supported by anything but assets of highly questionable, minimal value and the value used throughout was overstated and rigged to create a large charitable deduction where none existed. Therefore, the donation of the stock lacked economic substance, and was not a charitable contribution within the meaning of IRC § 170(a).

The third area of contention from the taxpayers is whether the exempt party had a beneficial interest in the S corporation upon the purported transfer of the S corporation's nonvoting stock. Or, stated another way, whether a change of economic interest (something of value) occurred, as the result of the transfer.

The exempt parties were not independent shareholders because there was an understanding that the exempt parties merely would hold the stock for the original shareholders for a short period of time, then the stock would be redeemed. The exempt parties did not enjoy the economic benefits of the nonvoting stock, because the S corporations made few or no actual distributions. Moreover, the exempt parties could not sell the nonvoting stock, as there were no "willing buyers."

Settlement Guideline

Each step of the transaction
appears to have been done based on statutory requirements. However, when all the steps are put together, the result of the transaction was not what Congress intended under subchapter S of the IRC. There was no donative intent and the transaction was done with tax avoidance as the primary motive. Although some of the exempt parties were receiving redemption amounts greater than the original value of the nonvoting stock, and, ordinarily, this could indicate that it was a true corporate/shareholder situation, the fact that in the beginning the

nonvoting stock was guaranteed to not go below a certain price[8] strongly indicates that the exempt parties did not have the risk of losing stock value with which a real shareholder would be faced.

The purported donation (transfer)
was made as part of a prearranged tax shelter plan. The donation resulted in 90% of the S corporation's income being diverted to a tax indifferent party, the exempt party.[9] While the exempt party owned the nonvoting stock, the S corporation made few, if any, distributions. This indicates that the transferor retained the economic benefits of the stock ownership. Subsequently, after the exempt party held the nonvoting stock for a short period of time, the S corporation or the original shareholder redeemed the nonvoting stock. Also, the warrants were used as a means to ensure that the exempt party would resell the nonvoting stock to the original owner. This indicates that there was no intent to donate the nonvoting stock, but rather to temporarily shift it to the exempt party. Once the exempt party was removed, the owners of the S corporation voting stock were free to make distributions to the original shareholders.

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There was no reason to engage in this transaction except for tax reasons, such as the deferral of taxes for at least 2-3 years and the conversion of ordinary income into capital gains. The transfer of the nonvoting stock was merely an illusory part of this sham transaction. If the taxpayer genuinely wanted to make a gift to the exempt party, it could have made a donation in cash.

Consequently, Appeals' believes there was no reason to engage in this transaction except for tax purposes and, therefore, it lacked economic substance. The transaction was structured in such a way that the S corporation never lost control, ownership and the benefits of the nonvoting stock, similar to Mount Mercy Associates, supra. Furthermore, this transaction was inconsistent with the intent of the Congress in enacting subchapter S of the IRC, the value claimed on the nonvoting stock cannot be supported,[10] and the transaction was used to create large tax benefits where none existed, similar to Torney, supra.

[8] In the beginning, pledge agreements from the original shareholder were made to guarantee the exempt parties the redemption price would not be any lower than the original stated value. Subsequently, the original shareholders became uncomfortable with this pledge, thus they were discontinued in the later transactions.
[9] A prudent businessperson would not give 90% of his/her business to a stranger for a few years.
[10] See issue 3 below for a discussion with respect to the nonvoting stock value.

Issue 2:

Government's Position

Alternatively, the capital structure created in the Notice 2004-30 transaction violates the single class of stock requirement of IRC § 1361(b)(1)(D) and § 1.1361-1(l). The Government asserts that: (1) the instrument (warrants) is substantially certain to be exercised; (2) the strike price is substantially below the fair market value of the underlying stock on the date the instrument is issued; (3) there was no good faith determination of fair market value because it was substantially in error, and was not performed with reasonable diligence to obtain a fair value; and (4) because of the redemption agreement, the exempt parties won't receive a distribution or liquidation proceeds commensurate with its stock ownership.

Taxpayers' Position

The taxpayer argues that: (1) the warrants are substantially certain not to be exercised; (2) even if the strike price is below the fair market value of the underlying stock, the Government must prevail on assertions (1) and (3) with respect to the warrants; (3) the fair market value was appraised by independent and competent appraisers; and (4) the exempt parties had the right to distributions or liquidation proceeds equal to the original shareholders, while owning the nonvoting stock.

Discussion

A. Government's Analysis

Section 1361 defines "small business corporation" and sets forth limitations on the capital structure of an S corporation. The capital structure of an S corporation is limited to one class of stock pursuant to § 1361(b)(1)(D). When an S corporation ceases to meet the limitations set forth in § 1361(b), its status as an S corporation is immediately terminated. Based on the facts and circumstances of the individual cases, the arguments described below should be made.

Except as provided in § 1.1361-1(l)(4), a corporation is treated as having only one class of stock if all of its outstanding shares confer identical rights to distributions and liquidation proceeds. § 1.1361-1(l)(1). Section 1.1361-1(l)(4)(iii)(A) provides, in part, that a call option, warrant or similar instrument issued by a corporation is treated as a second class of stock of the corporation if, taking into account all of the facts and circumstances, the instrument is substantially certain to be exercised by the holder and has a strike price substantially below the fair market value of the underlying stock on the date that the instrument is issued. Section 1.1361-1(l)(4)(iii)(C) provides that warrants will not be treated as a second class of stock if they have a strike price that is at least 90 percent of the fair market value of the underlying stock on the dates they are issued. For this purpose, a good faith determination of fair market value by the corporation will be respected, unless it can be shown that the value was substantially in error, and the determination of the value was not performed with reasonable diligence to obtain a fair value.

The Government proposes that the warrants in these transactions are a second class of stock. The warrants have an exercise price that is substantially below the fair market value of the underlying stock, which is the nonvoting stock that would be issued if the warrants were exercised (the warrant stock). The parties often set the exercise price of the warrants as a percentage of the purported value of the stock held by the exempt party, rather than by reference to the value of the warrant stock. For this purpose, the parties determine the value of the exempt party's stock by treating the warrants as exercised, and by applying additional discounts to the value of the nonvoting stock for minority interest and lack of marketability and control. The value of the warrant stock is greater than the value of the stock held by the exempt party because the factors that depress the value of the exempt party's stock are not equally applicable to the warrant stock. Thus, the Service may argue that whether or not the exercise price of the warrants is at least 90 percent of the fair market value of the stock held by the exempt party, the exercise price of the warrants is substantially below the fair market value (on the date that the warrants are issued) of the warrant stock.

In addition, for purposes of § 1.1361-1(l)(4)(iii)(A), the warrants will be treated as substantially certain to be exercised. The effect of the warrants and other agreements is to maintain the original shareholders' equity ownership. As a result of the warrants and the other agreements, the original shareholders maintain their S corporation equity ownership at either 100 percent (if the stock of the exempt party is redeemed) or nearly 100 percent (if the warrants are actually exercised). Because the holders of the warrants would be economically compelled to exercise the warrants if the exempt party's stock is not redeemed, it is substantially certain that the original shareholders will enjoy the economic effect of exercising the warrants. Thus, the warrants will be treated as substantially certain to be exercised.

The safe harbor in § 1.1361-1(l)(4)(iii)(C) does not apply to the warrants. The taxpayers did not seek or receive a valuation of the shares underlying the warrants (i.e., the warrant stock). In some cases, the appraisals may significantly understate the value of the corporation's business or may understate the value of the nonvoting stock held by the exempt party. Whether or not the appraisal in a particular case has these flaws, the exercise price of the warrants is substantially less than 90 percent of the fair market value of that stock. The appraisals are substantially in error and were not performed with reasonable diligence, because the appraisals valued the stock held by the exempt party rather than the stock that would be issued if the warrants were exercised. Finally, if the facts of a particular case indicate that an appraiser knew or had reason to know that the appraisals were being made in order to facilitate the improper avoidance of tax on the income from the corporation's business, the appraisal does not qualify as a good faith determination of fair market value.

Additionally, § 1.1361-1(l)(2)(iii) provides that redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless: 1) a principal purpose of the agreement is to circumvent the one class of stock requirement; and 2) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.

In Notice 2004-30 transactions, the effect of the redemption agreements and various other instruments is to assure that the exempt party, to which 90 percent of the income is allocated, will never receive distribution or liquidation proceeds commensurate with its purported stock ownership, thereby circumventing the single class of stock requirement. Moreover, the structure of the transaction results in the manipulation of the purchase price of the shares upon redemption to ensure that the purchase price, while purportedly at fair market value, reflects a price substantially below that to be expected for shares reflecting 90 percent ownership of the S corporation.

Section 1.1361-1(l)(4)(ii)(A) provides that any instrument issued by a corporation is treated as a second class of stock if the instrument constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law and a principal purpose of issuing the instrument is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock. In some Notice 2004-30 transactions, the facts may show that the warrants constitute equity or otherwise result in the holder being treated as the owner of stock under general principles of Federal tax law.

B. Taxpayers' Analysis

The taxpayer argues that it does not appear that the issuance of the Class B nonvoting common stock will create a second class of stock. The Class B has identical rights to distribution and liquidation proceeds as the Class A voting common stock owned by the shareholders.

The distribution of the warrants should not create a second class of stock under the safe harbor provision of Treas. Reg. § 1.1361-1(l)(4)(iii)(C), which provides that if the strike price of the warrants is at least 90% of the FMV of the underlying stock on the date they are issued, the warrants should not be considered a second class of stock.

However, the IRS will treat the warrants as a second class of stock if the warrants are substantially certain to be exercised by the holder and have a strike price substantially below the FMV of the underlying stock. There is a safe harbor provision, which provides that if the strike price of the warrants is at least 90% of the FMV of the underlying stock on the date they are issued, the warrants are not considered a second class of stock.

With respect to the second argument, the regulations state that a "good faith determination of fair market value by the corporation will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable due diligence to obtain a fair value." Since the S corporation typically engages qualified valuation professionals and relies upon their expertise, it cannot be said that the valuation was performed without reasonable due diligence.

Even if the Service were to prevail regarding the safe harbor, the regulations state that the "failure of an option to meet this safe harbor will not necessarily result in the option being treated as a second class of stock."

Since the warrants issued by the S corporation meet this safe harbor provision, it would be unlikely that the Service could argue that the warrants are substantially certain to be exercised. Accordingly, the Service should not be able to re-characterize the warrants as stock under Revenue Ruling 82-150.

Additionally, the courts have been reluctant to re-characterize warrants as stock. In Graney, 258 F. Supp. 383, aff'd, 377 F. 2d 992 (4th Cir. 1967) cert. denied, 389 U.S. 1022 (1967), a corporation issued its president an option to purchase stock at a price substantially below the market value of such stock, exercisable over a 5 year period. The Government asserted the arrangement was an option and the excess of the FMV of the stock over the option premium was ordinary income, when the option was exercised. The taxpayer claimed that the warrants were a sale of the stock and the excess was long-term capital gains. The court agreed with the Service noting that, although the contract vested a number of

ownership rights in the president, those rights were extended by the terms of the agreement and not by virtue of ownership of the stock itself, and that the option did not impose an obligation upon the president to buy the stock.

The present situation is less extreme than Graney. In Graney, the underlying stock was actually placed in escrow. Moreover, the option holder had the right to exercise all shareholder rights associated with the stock. Here, the underlying stock has not been placed in escrow and the warrant holder has no right to exercise shareholder rights associated with the underlying stock. Accordingly, under Graney, the warrants should not be re-characterized as stock.

Another taxpayer argues that, under the regulations, the Service must prevail in two respects in order to establish that the warrant constituted a second class of stock. First, the Service must show that the warrant had an exercise price substantially below fair market value. Second, the IRS must demonstrate that the warrants were substantially certain to be exercised.

The warrants were exercisable at 90% of the appraised fair market value of the underlying stock, nowhere near the 50% discount deemed "substantial" in the regulations. And even if in a battle of valuation experts the Service could sustain an argument that the value of the stock was substantially greater than the exercise price, there is simply no way to demonstrate that the warrant was substantially certain to be exercised. This is not a typical situation where proving that the exercise price is far below the fair market value of the stock might go a long way proving that the warrant will be exercised. Instead, by the nature of the structure of the SC2 transactions, the warrant in this case would almost certainly not be exercised in most eventualities. The shareholder already owns all of the outstanding stock of the Company except for the stock held by the exempt party and does not need to exercise the warrants if the exempt party's stock is redeemed.

Even though it was not necessary to satisfy the 90% safe harbor, the Company and the shareholder chose to do so. Thus, because they engaged the appraiser to perform an appraisal the date they were issued, the warrants are not considered a second class of stock.

C. Appeals' Analysis

Taxpayers argue there are three tests upon which the Government must prevail for the warrants to be considered a second class of stock.

The first test is whether the instrument (warrants) is substantially certain to be exercised. In form, there is no substantial certainty that the warrants will be exercised. The transaction calls for the nonvoting stock to be redeemed or repurchased from the exempt party. The warrants are merely to insure the original shareholder that, if the exempt party would refuse to sell back the

nonvoting stock, then the original shareholder could acquire enough nonvoting stock (90,000 shares in the typical situation) to dilute the 9,000 shares of nonvoting stock owned by the exempt party (from 90% to 9%). Apparently, no warrants have been exercised to this date.

The second test is whether the strike price (of the warrants) is substantially below the fair market value of the underlying stock on the date the instrument is issued. The Government's position is that the wrong nonvoting stock was valued for this test. In other words, the taxpayer valued the shares of nonvoting stock actually held by the tax-exempt and the Government claims that the shares that would be issued upon exercise of the warrants should have been valued instead.[12] Typically, the Government has not provided valuation reports with respect to its methodology. However, the taxpayers argue that even if the Government is correct, it must also prevail on the other two tests.

The third test pertains to whether there was a good faith determination of the fair market value and it will be respected unless it was substantially in error, and the determination of the value was not performed with reasonable diligence to obtain a fair value.

The taxpayers claim that they would testify that, through legal advice, the S corporations had the shares of nonvoting stock appraised and the appraisal was reasonable at that time. Typically, taxpayers hire an independent qualified appraiser to value the stock. The taxpayers argue that they should not be expected to know that perhaps the wrong stock was valued.

The Government has also proposed that because of the redemption agreement, the exempt parties would not receive a distribution or liquidation proceeds commensurate with its stock ownership. In other words, the redemption agreement may be considered with respect to the issue of whether a corporation's outstanding stock conferred identical distribution and liquidation rights. The effect of the redemption agreement and the warrants were to assure the exempt party, to which 90% of the income was allocated, would never receive its share, accordingly. Thus, the transaction would circumvent the single class of stock requirement.

However, taxpayers argue that a court could decide that during the term of the transaction (2-3 years) the nonvoting stock had equal distribution and liquidation rights. Then, after the nonvoting stock was reacquired by the S corporation by redemption, which is a normal and legal business transaction, it would be allowed to make the distribution and liquidation proceeds to the original shareholder, because the exempt party was no longer an owner.

[12] The Government asserts that the value of the warrant stock is greater than the value of the stock held by the exempt party because the factors that depress the value of the exempt party's stock are not equally applicable to the warrant stock.

In addition, for redemptions to be considered for the issue of whether the outstanding stock had identical distribution and liquidation rights, the regulations have the provision that a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence. See Treas. Reg. § 1.1361-1(l)(2)(iii)(A)(2).

Settlement Guideline

The Government must prevail on three tests for the warrants to be a second class of stock, (1) - (3) above.

Issue 3:

Government's Position

The transfer of nonvoting stock to the exempt party does not qualify as a deductible charitable contribution pursuant to § 170 and should be disallowed.

Taxpayers' Position

The taxpayer donated nonvoting stock to the exempt party without expecting anything in return. The nonvoting stock was appraised by an independent qualified appraiser, who ascertained the fair market value.

Discussion

A. Government's Analysis

Section 170(a)(1) allows as a deduction, subject to certain limitations and restrictions, any charitable contribution (as defined in § 170(c)) that is made within the taxable year.

1. Charitable Intent

To be deductible as a charitable contribution under § 170, a transfer to a charitable organization must be a gift. A gift to a charitable organization is a transfer of money or property without receipt of adequate consideration, made with charitable intent. See U.S. v. American Bar Endowment, 477 U.S. 105, 117-118 (1986) (citing Rev. Rul. 67-246, 1967-2 C.B. 104, with approval); Hernandez v. Commissioner, 490 U.S. 680, 690 (1989); § 1.170A-1(h)(1) & (2). A transfer to a charitable organization is not made with charitable intent if the transferor expects a return commensurate with the amount of the transfer. Hernandez at 690; see also American Bar Endowment at 116; Singer Co. v. U.S., 449 F.2d 413 (Ct Cl. 1971) (charitable contribution deduction denied for discounts on product offered to public schools because donor company expected indirect return in the form of future increased sales of its product).

In a Notice 2004-30 transaction, the nonvoting stock was not transferred to the exempt party with charitable intent. The original shareholders transferred the nonvoting stock to the exempt party in order to allocate the S corporation's

income to the exempt party, and thereby avoid paying tax on S corporation income. The parties to the transaction entered into the transaction to generate a tax benefit for the original shareholders, not to benefit the exempt party. Further, the original shareholders expected a return from the transfer of the nonvoting stock to the exempt party, in the form of income sheltering, that is at least commensurate with any amount ultimately transferred to the exempt party. Therefore, a charitable contribution deduction taken on the transfer of the nonvoting stock to the exempt party should be disallowed.

In addition, the original shareholders may argue that they transferred an amount of stock equal to the economic benefits realized by the exempt party, or that they expected to transfer cash to the exempt party upon redemption of the nonvoting stock. However, under either argument the amount received by the exempt party was an accommodation fee, not a charitable gift, and it is therefore not deductible under § 170.

2. Conditional Gift

Section 1.170A-1(e) states that if, on the date of the gift, an interest in property would be defeated by the subsequent performance of some act or the happening of some event, the possibility or occurrence of which does not appear to be so remote as to be negligible, a charitable contribution deduction is not allowed. See also § 1.170A-7(a)(3).

As explained above, as a result of the warrants, the redemption agreements, and the other agreements, the original shareholders maintained their S corporation equity ownership at either 100 percent (if the stock of the exempt party is redeemed) or nearly 100 percent (if the warrants are actually exercised). Therefore, at the time of the purported gift of a 90 percent ownership interest in the S corporation by transfer of the nonvoting stock, the possibility that the exempt party's ownership interest in the S corporation will be defeated is not "so remote as to be negligible." Therefore, a charitable contribution deduction taken on the transfer of the nonvoting stock to the exempt party should be disallowed. If the exempt party is considered to be a shareholder to the extent of the actual economic benefit it realized, this argument would not be available.

3. Substantiation

A charitable contribution deduction is allowable only if substantiated in accordance with regulations prescribed by the Secretary. §§ 170(a)(1), (f)(8) and (f)(11); see Addis v. Commissioner, 374 F.3d 881 (9th Cir. 2004) (charitable contribution deduction denied because contemporaneous written acknowledgment required by § 170(f)(8) inadequate). Under § 170(f)(8), a taxpayer must substantiate its contribution of $250 or more by obtaining from the donee a contemporaneous written acknowledgment that includes a statement as to whether goods or services were received (or are expected) by the donor from

the donee, and a good faith estimate of the value of such goods or services. § 1.170A-13(f)(6). Under § 170(f)(8)(C), a written acknowledgment is contemporaneous if it is received by the donor on or before the earlier of the filing of the return on which the charitable contribution deduction is taken, or the due date of the return (including extensions). In addition to the contemporaneous written acknowledgment, a donor taking a charitable contribution deduction of more than $5,000 for the contribution of property must obtain a qualified appraisal and file with the return an appraisal summary on Form 8283. § 1.170A-13(c)(2)(i). Section 1.170A-13(c)(3) of the regulations contains numerous detailed requirements on what constitutes a qualified appraisal. For contributions made after June 3, 2004, § 170(f)(11)(D) requires the donor to attach the qualified appraisal to its return for the year in which the contribution is made.

An examination of a charitable contribution deduction should include an examination of whether the substantiation requirements were met. If they were not, the charitable contribution deduction may be challenged.

B. Taxpayer's Analysis

The taxpayer argues that the Supreme Court has specifically addressed the test for determining whether a charitable contribution is valid in American Bar Endowment, supra. It basically said that the sine qua non of a charitable contribution is a transfer of money or property without adequate consideration. In Hernandez, supra, the Supreme Court concluded that the external features of the transaction, and not the motivations of individual taxpayers, need to be examined to determine whether such an expectation existed.

Pursuant to the Supreme Court, it appears that the test for determining whether a charitable contribution is valid is whether there is an expectation of a quid pro quo to be received from the donee. In Hernandez, for example, the taxpayer's deductions were disallowed because the contributions were, in reality, payments to a church for certain hourly training services. With regard to the proposed transaction however, there is no expectation of receiving a benefit from the exempt party. The exempt party does not exchange goods or services for the nonvoting stock and the shareholder is not a member of the exempt party.

It does not appear that the tax benefits the shareholder may receive from making the contribution should be considered to be a quid pro quo for the contribution. First, it is not the exempt party which provides these benefits to the shareholder. All the exempt party does is accept the gift of stock and sign the redemption agreement. Moreover, the exempt party is free to sell or transfer the stock at any time, so long as the transfer will not invalidate the S corporation's S election. The shareholder obtains the tax benefits of the transaction due to the Subchapter S income allocation rules in the Code. Moreover, it is the S Corporation which determines and reports the income allocation of the S corporation to the Service, not the exempt party. If the shareholder does not receive the anticipated tax

benefits, either because they are disallowed by the Service or there is a law change, the shareholder has no right to ask for any remuneration from the exempt party or to rescind the contribution. Therefore, it does not appear that there is any quid pro quo exchange here, as articulated by the Supreme Court.

In fact, in Weitz v. Commissioner, T.C. Memo. 1989-99 (1999), a taxpayer's deduction was allowed even though the charitable contribution was solely motivated by a tax benefit. The Tax Court said that a charitable contribution may be motivated by the basest and the most selfish of purposes as long as the donor does not reasonably anticipate benefit from the donee in return.

1. Charitable Intent

Another taxpayer argues that the leading case in this area is Skripak v. Commissioner, 84 T.C. 285 (1985). Skripak involved charitable contributions made as part of a tax shelter program pursuant to which taxpayers donated units of participation in a book contribution program. The court found that taxpayers understood little of the transaction and virtually had no chance of making a profit on the books. Nevertheless, the court was convinced that taxpayers purchased the books from the program promoter and contributed the books to various charities. In so finding, the court stated that “doctrines such as business purpose and an objective of economic profit are of little significance in determining whether petitioners have made charitable gifts.” Skripak, at 315. The court also noted that the Government appeared to be obsessed with the mechanics of the transactions as shams, which the court attributed to the admitted tax avoidance motivations of the various petitioners, and instructed that “a taxpayer’s desire to avoid or eliminate taxes by contributing cash or property to charities cannot be used as a basis for disallowing the deduction for that charitable contribution.” Skripak, at 319.

Skripak was followed by Weitz, supra, which went through the elements of an inter vivos gift. These elements are: (1) a donor competent to make a gift; (2) a donee capable of taking a gift; (3) a clear and unmistakable intention on part of the donor to absolutely and irrevocably devise himself of the title, dominion and control of the subject matter of the gift in praesenti; i.e. at the time of the gift; (4) the irrevocable transfer of the present legal title and of the dominion and control of the entire gift to the donee so that donor can exercise no further act dominion or control over it; (5) delivery by donor to the donee of the subject gift or of the most effectual means of commanding the dominion of it; and (6) acceptance of the gift by the donee.

The issue in Mailman v. Commissioner, T.C. Memo. 1989-88, involved a contribution of stock to a hospital. The Government argued that the petitioner had received significant "economic benefits" as a result of a transfer of stock, thereby precluding the charitable contribution. The term charitable contribution used in § 170 is synonymous with the word gift, citing DeJong v. Commissioner,

36 T.C. 896 (1961), where it adequately deals with the issue of whether economic benefits due to taxpayers result from the transfer and concluded that there were no such economic benefits. It went on to value the stock and determine the amount of the contributions.

In a typical Notice 2004-30 transaction, the shareholders contributed nonvoting stock to the exempt party. The nonvoting stock was delivered and accepted by the exempt party. In the exempt party's acknowledgment of the receipt of certificates, the exempt party recognized the stock was nonvoting and the corporation had issued tax free dividends of warrants to purchase additional nonvoting common stock in the corporation to the original shareholder, which did not include the exempt party. The acknowledgement of receipt also noted that, if warrants were exercised by the holders, the exercise would have the effect of diluting the ownership interest in the corporation represented by the charitable contribution of shares referred to above. However, it was not anticipated that the actual exercise of the warrants would have a negative impact on the valuation of the purchase price established by the firm that appraised the stock. Thus, there was charitable intent.

2. Conditional Gift

The stock was given, transferred, and received. If the CIP intended to mean that the exempt party might reconvey its stock to the taxpayer, such possibility is inherent in all buy/sell or redemption agreements. In such instances the transfer is not being defeated, but recognized. What was unknown was the price at which the stock would be redeemed. A quick look at the stock transfer reveals absolute transfer, unconditionally. It is possible that the stock would decrease in value if the corporation's performance during the ownership by the exempt party declined. On the other hand, it is possible the stock would increase in value if the corporation's performance improved. In fact, in some cases the corporate value improved slightly during the period of ownership of the stock by the exempt party by the date of redemption. There was no possibility that the exempt party's interest in the S corporation's stock would be defeated.

3. Substantiation

The exempt party did file the necessary return and made the necessary reported statements. Form 8283 has been completed by all the relevant parties.[15]

[15] The taxpayer had the nonvoting stock appraised pursuant to Rev. Rul. 59-60, 1959-B-1 CB 237.

C. Appeal's Analysis

Appeals recognizes that most of the exempt parties that received the nonvoting stock considered the purported donation to have no value and thus, did not record the stock as an asset. The other exempt parties recorded the nonvoting stock as an asset but merely used the appraised value provided by the original shareholder without doing their own valuation.

When a taxpayer contributes property other than money, the amount of the contribution is the fair market value at the date of the contribution, subject to certain reductions. § 1.170A-1(c)(1).

"Fair Market Value" is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." § 1.170A-1(c)(2).

Champlin v. Commissioner, 31 B.T.A. 587 (1934), stated that before the Commissioner is authorized to value the assets of a corporation for the purpose of arriving at the value of its stock, he must first determine that there is a fair market value for the stock. There were no offers to buy or sell this stock at any time in controversy. This in itself is strong proof that there was no market. Thus, the evidence conclusively shows, without contradiction, that this stock had no fair market value.

In O'Meara v. Commissioner, 34 F.2d 390 (10th Cir. 1929), the Tenth Circuit stated that the petitioner sustained the burden of proof that there was no market for such stock. The petitioner testified that there was no market for the stock of the Orlando Company; that the stock was speculative in character; that none of the stock had been offered for sale and that he knew of no person offering to buy it; that there were transactions in oil leases but he knew of no transactions in stock; that he knew of no person who was in the market to buy Orlando Company's stock; that he knew of no place where he could have realized cash for his stock and that he could not have sold his stock in the Orlando Company. The court decided that stock for which there is no market -- which could not be sold or could not be sold for an amount reasonably approximate to its real or intrinsic value -- has no market value within the meaning of Sec. 202(b) of the Revenue Act of 1918.

The court went on further to state that no doubt cases may arise where intrinsic value may be resorted to for the purpose of establishing market value. For example, where stock is closely held and there are no sales thereof on the open market but where, from proven facts and circumstances, there could be no doubt of the existence of a market for the stock at a fair price if the same were offered for sale. In such case, however, it would be necessary to show not only that

there were no sales which reasonably reflected the market value but that there would be a market value if the stock were offered for sale. Id. at 395.

In M.F.A. Central Cooperative v. Bookwalter, 286 F. Supp. 956 (E.D. Mo. 1968), 427 F2d. 1341, reversed and remanded for an unrelated issue, the Class C stock issued by the cooperative bank as a patronage dividend did not have a fair market value at the time of issue. Class C stock may be issued only to banks for cooperatives and farmers' cooperative associations. The only reason the Class C stock was purchased was because it was a condition imposed by the bank in making the loan. This Class C stock could not be disposed of except to another eligible cooperative, and then only with the permission of the bank. It paid no dividends and possessed no rights. Thus, based on the nature of the Class C stock as discussed, the court is of the opinion that the Class C stock issued by the St. Louis Bank for Cooperatives did not have a fair market value at the time it was issued.

Torney v. Commissioner, T.C. Memo. 1993-385, involved a charitable deduction of stock. The Government's expert considered a variety of factors in arriving at his valuation. One important factor was that there was no legitimate demand for the stock, so if the petitioners had tried to sell their shares, the market would not have been able to absorb those shares. Based on this and other criteria, the expert concluded that the stock had little or no value. The Tax Court agreed with the Government's expert and decided that the stock had no value.

Settlement Guideline

Appeals believes that there was no # donative or charitable intent needed to support a § 170 deduction or that the transfer was a conditional gift that fails to qualify for a § 170 deduction. Even if it were determined that a gift was made, there is a possible lack of substantiation.

The transfer of nonvoting stock to # the exempt party was step 3 of the prearranged plan discussed in Issue 1 above. The nonvoting stock was merely "parked" with the exempt parties. The original shareholder was expecting tax benefits far greater than the purported charitable contribution. Thus, there was no donative intent. Further, the transfer was a conditional gift, a deduction for which is not permitted because the possibility that the exempt party's ownership interest in the S corporation will be defeated is not "so remote as to be negligible." The purported contribution was, in reality, the vehicle used by the original shareholders to shelter income at the cost of paying the exempt parties an accommodation fee when the nonvoting stock is redeemed.

Appeals is convinced that the nonvoting stock transferred to the exempt parties had zero value. Therefore, even if the taxpayer purports to substantiate the value claimed with an appraisal, the true value was zero.

Based on the record, there is overwhelming evidence that there was no willing buyer or market for the nonvoting stock. The nonvoting stock had so many restrictions that it would be unattractive to most purchasers. For example, no one would pay $500,000 for nonvoting stock in order to be allocated $3 million of S corporation income (without any distributions attributable to the $3 million) and end up paying $1,158,000 (38.6%) in income tax on the S corporation income, for each year. Moreover, when sold 2-3 years after purchase, the maximum benefit received from any appreciation of the stock would be limited to 9% and not 90%, because the valuation method involves the assumption that all the warrants have been exercised. Thus, from the exempt party's perspective, it was inconceivable that it could ever find a willing buyer.[16]

The exempt parties were correct when they determined the nonvoting stock had zero value. Also, the market for the exempt party to sell the stock is severely limited because most holders of this stock would incur more tax liability than the stock is worth. The truth of the matter is that no prudent buyer would want this particular stock, even if it was free.[17]

With respect to the taxpayer's position, Rev. Rul. 59-60 assumes that there are willing buyers, if put up for sale. However, this assumes the purchase of the stock would be attractive to buyers, knowing all the facts and circumstances. However, that is not the fact in the Notice 2004-30 transaction, the nonvoting stock would be unattractive, as discussed above.

The authorities cited above tell us that one must have a willing buyer and a market in order to have any fair market value. And, if book value or intrinsic value of the corporation is used in the analysis of the fair market value,[18] it must still be established that there would be a market, if the stock were offered for sale. There was no market for the Notice 2004-30 nonvoting stock.

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[16] It is Appeals' opinion that the transaction had to be structured so that there would be no willing buyers for the exempt party's nonvoting stock. Otherwise, the original shareholders would not be comfortable in giving away 90% of the S corporation, which could result in a shareholder who was an uncooperative accommodation party.

[17] While it is obvious that any taxable entity would not purchase the nonvoting stock, one may argue that there would be some value to tax exempt investors. The market for nonvoting stock in a closely held corporation is already so narrow, that if narrowed further by excluding all taxable entities, it would be virtually non-existent. Furthermore, defining a value only to tax exempt entities would not meet the common definition of fair market value which envisions a hypothetical willing buyer and willing seller, not a specific class of buyers or sellers. These narrowly defined values are normally referred to as investment value, not fair market value.

[18] This was the methodology used by the taxpayers' appraisers to ascertain the fair market value of the nonvoting stock.

Issue 4:

Government's Position

The transaction costs incurred in connection with the Notice 2004-30 transaction, including promoter's fees, accounting fees, legal fees, appraisal fees, and redemption payments recharacterized as accommodation fees, are not deductible under §§ 162, 165, or 212.

Taxpayers' Position

There should be no issue with respect to the deductibility of the transaction costs. Certainly, the amounts paid for tax advice and documentation concerning transfers to the charitable organizations are deductible.

Government's Analysis

Section 162 provides generally for the deduction of ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. However, transaction costs incurred in connection with a transaction designed solely to provide tax benefits for participants are not deductible under § 162. See Brown v. Commissioner, 85 T.C. 968, 1000 (1985), aff'd sub nom. Sochin v. Commissioner, 843 F.2d 351 (9th Cir. 1988); see also Leslie v. Commissioner, 146 F.3d 643, 650 (9th Cir. 1998) (deduction disallowed for fees paid to purchase deductions in tax-motivated transaction, citing Brown); Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 294 (1999) (administrative fees disallowed as the product of a sham), aff'd, 254 F.3d 1313 (11th Cir. 2001); Price v. Commissioner, 88 T.C. 860, 886 (1987), aff'd without published opinion, 1990 U.S. App LEXIS 20422 (10th Cir. Oct. 26, 1990) (deduction for fees paid to acquire tax losses disallowed because neither a cost of doing business nor incurred with an intent to make a profit independent of tax consequences, citing Brown).

The transaction costs incurred by the original shareholders or by the S corporation in conjunction with the Notice 2004-30 transaction, including promoter's fees, accounting fees, legal fees, appraisal fees, and payments made to exempt parties recharacterized as payment for services as accommodation parties, are paid for participation in the transaction. The Notice 2004-30 transaction is crafted to shelter income otherwise taxable to the original shareholders and serves no business purpose of either the original shareholders or the S corporation. The fees incurred constitute payments to purchase tax benefits for the original shareholders and, as such, are not deductible under § 162 by either the S corporation or original shareholders.

Section 212 generally provides for the deduction by an individual of ordinary and necessary expenses paid or incurred during the taxable year: (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax. Only § 212(3) is possibly relevant to the instant case. Deductions under § 212(3), however, cannot be taken for costs incurred in obtaining tax advice in furtherance of a sham transaction. See Dooley v. Commissioner, 332 F.2d 463, 468 (7th Cir. 1964); see also Brown v. Commissioner, 85 T.C. at 1000. Accordingly, the original shareholders may not take a deduction under § 212 for the cost of tax advice obtained in furtherance of a Notice 2004-30 transaction.

Section 165(a) and (c)(3) generally allow a taxpayer to deduct losses arising from the theft of property. However, courts have disallowed a § 165 “theft loss” deduction for the out-of-pocket costs of participating in sham transactions, because the taxpayers received what they expected from the transactions. Marine v. Commissioner, 92 T.C. 958, 974-980 (1989); aff'd without published opinion, 921 F.2d 280 (9th Cir. 1991); Viehweg v. Commissioner, 90 T.C. 1248, 1255 (1988). Accordingly, as with claims for deductions under §§ 162 and 212, deductions for theft losses claimed by participants in Notice 2004-30 transactions should be disallowed.

Settlement Guideline

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In cases where there is a "sham transaction" issue and the
Government is sustained, the courts have held that associated transaction costs that don’t have significance apart from the shelter transaction are not deductible.

The promoter fees, accounting
fees, and legal fees, and appraisal fees are costs associated with this sham transaction. The redemption payments are disguised accommodation fees to the exempt parties.

The use of the exempt parties as accommodation parties is similar to the use of an Indian tribe in a tax shelter pertaining to a lease strip transaction. The Indian tribe had no active role in the lease strip other than its participation allowed others to exploit its tax exempt status. The Indian tribe was allocated the lease rental income, paid no Federal income tax on it and received an accommodation fee of between $17,000 to $40,000 at the closing of each transaction. See CMA Consolidated, Inc. & Subsidiaries, Inc., T.C. Memo. 2005-16.

Likewise, in the instant case, the exempt parties were exploited because they could be a qualified S corporation shareholder, and at the same time were tax exempt. Thus, they would be willing to be allocated the S corporation income

without the corresponding distributions. The integral fact was the exempt parties' tax exempt status.

Moreover, since the nonvoting stock had zero value, the payments made for the redemption or repurchase of the nonvoting stock from the exempt parties could be nothing other than a disguised accommodation fee. The accommodation fees were substantially all the benefits received by the exempt parties.[19]

If a transaction cost is an integral part of a tax shelter scheme and that scheme is determined to be a sham, no deductions will be allowed for the transaction costs. As sham transactions lack economic substance, they do not give rise to valid deductions or losses even for the taxpayer's out of pocket cash investment such as transaction costs. Case law precludes the deduction of out of pocket or transaction costs in sham transactions. See Brown v. Commissioner, supra, Winn-Dixie Stores, Inc. v. Commissioner, supra and Leslie v. Commissioner, supra. The transaction costs in question were incurred in connection with, and were an integral part of, a sham transaction (Issue 1).

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Issue 5:

Government's Position

Generally, the accuracy-related penalty under § 6662 for negligence or disregard of rules or regulations and/or a substantial understatement of income tax should be developed and considered for taxpayers who engaged in Notice 2004-30 transactions.

Taxpayers' Position

The penalties are not relevant to this transaction in as much as this was a legitimate contribution of substantial stock to the exempt party, which was

[19] There were insignificant amounts of distributions and dividends paid to the exempt parties. Also, dividends were paid to the exempt parties in order to extend the redemption period.

received by the exempt party, used by the exempt party and ultimately redeemed by the corporation in exchange for the fair market value of the stock.

The taxpayers find it difficult to understand how an accuracy-related penalty could somehow be justified by the Service. The taxpayers argue that reliance on the Palmer line of cases and § 1.1361-1(l)(4)(iii)(C), along with obtaining comprehensive appraisals from well qualified and respected firms eliminate any claims by the Service for negligence, lack of substantial authority, or lack of good faith.

Government's Analysis

Whether penalties apply to underpayments generated by a Notice 2004-30 transaction must be determined on a case by case basis, depending on the specific facts and circumstances of each case. The application of a penalty must be based on a comparison of the facts developed with the legal standard for the application of the penalty.

A. The Accuracy-Related Penalty

Section 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations; and (2) any substantial understatement of income tax. Section 1.6662-2(c) provides that there is no stacking of the accuracy-related penalty components. Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20 percent (40 percent in the case of a gross valuation misstatement), even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial understatement). See DHL Corp. v. Commissioner, T.C. Memo. 1998-461, aff'd in part and rev'd on other grounds, remanded, 285 F.3d 1210 (9th cir. 2002), where the IRS alternatively determined that either the 40 percent accuracy-related penalty attributable to a gross valuation misstatement under § 6662(h) or the 20 percent accuracy-related penalty attributable to negligence was applicable. The accuracy-related penalty provided by § 6662 does not apply to any portion of an underpayment on which a penalty is imposed for fraud under § 6663. § 6662(b).

1. Negligence

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. See §§ 6662(c) and 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499 (5th Cir. 1967), aff'g in part and remanding in part, 43 T.C. 168 (1964). Section 1.6662-3(b)(1)(ii) provides that negligence is

strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. The accuracy-related penalty attributable to negligence may be applicable if the taxpayer failed to make a reasonable attempt to evaluate the Notice 2004-30 transaction properly.

Common factors that suggest negligence include: the transactions are proposed and accepted within a very short time frame, often just prior to the end of the tax year; the taxpayer is unable to provide any evidence that due diligence was completed prior to entering into the transaction; and the taxpayer relied solely upon information provided by the promoter, without doing any independent investigation of the purported tax benefits.

2. Substantial Understatement

A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 in the case of corporations other than S corporations or personal holding companies).[20] § 6662(d)(1). Understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for the treatment, and (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. § 6662(d)(2)(B).

If the item is attributable to a tax shelter, however, it is more difficult for a taxpayer to obtain a reduction. For purposes of the penalty for a substantial understatement of income tax, a tax shelter is a partnership or other entity, an investment plan or arrangement, or other plan or arrangement where a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax. § 6662(d)(2)(C)(iii)[21].

If the taxpayer is an individual or other noncorporate taxpayer, an understatement attributable to a tax shelter item is generally reduced by the portion of the understatement attributable to the tax treatment of items for which there was substantial authority for such treatment if the taxpayer reasonably believed that the tax treatment of the item was more likely than not the proper

[20] On October 22, 2004, the American Jobs Creation Act of 2004, Pub. L. No. 108-357, amended § 6662(d)(1)(B) to provide that the substantial understatement for corporations must exceed the lesser of: (i) 10 percent of the tax required to be shown on the return (or, if greater, $10,000); or (ii) $10,000,000. Section 6662(d)(1)(B), as amended, is effective for tax years beginning after October 22, 2004.

[21] The American Jobs Creation Act of 2004 also removed the special rules in cases involving tax shelters. For taxable years ending after October 22, 2004, no taxpayer may reduce the amount of an understatement for items attributable to a tax shelter.

treatment. § 6662(d)(2)(C)(i). By contrast, if the taxpayer is a corporation and the understatement is attributable to a tax shelter item, the amount of the understatement cannot be reduced. § 6662(d)(2)(C)(ii). Therefore, if a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy-related penalty applies to the underpayment attributable to the understatement unless the reasonable cause exception applies. See § 1.6664-4(f) for special rules relating to the definition of reasonable cause in the case of a tax shelter item of a corporation.

In this case, the transaction fits within the definition of a tax shelter. Thus, no reduction in the understatement will be available for the shareholder unless there was substantial authority for the tax treatment of the item and the taxpayer reasonably believed that it was more likely than not the proper treatment.

Section 1.6662-4(d)(2) provides that the substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. It is less stringent than the "more likely than not" standard (the standard that is met when there is a greater than 50% likelihood of the position being upheld), but more stringent than the "reasonable basis" standard required to avoid the negligence penalty under § 1.6662-3(b)(3). There is substantial authority for the tax treatment of an item only if the weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. § 1.6662-4(d)(3). For a discussion of how to analyze whether there is substantial authority see § 1.6662-4(d)(3)(ii).

A taxpayer is considered to have reasonably believed that the tax treatment of an item is more likely than not the proper tax treatment if: (1) the taxpayer analyzes the pertinent facts and authorities and, based on his or her independent analysis, reasonably concludes in good faith, that there is a greater than 50 percent chance that the tax treatment of the item will be upheld if challenged by the Service, or (2) the taxpayer reasonably relies, in good faith, on the opinion of a professional tax advisor, which clearly states (based on the advisor's analysis of the pertinent facts and authorities) that the advisor concludes there is a greater than fifty percent likelihood the tax treatment of the item will be upheld if the Service challenges it. § 1.6662-4(g)(4)(i)(A) & (B). Moreover, if the taxpayer is relying on tax advice to establish reasonable belief, the taxpayer must also meet the requirements generally applicable to relying on advice to establish good faith and reasonable cause. See § 1.6662-4(g)(4)(ii).

B. The Reasonable Cause Exception

The accuracy-related penalty does not apply with respect to any portion of an underpayment with respect to which it is shown that there was reasonable cause

and that the taxpayer acted in good faith. § 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case by case basis, taking into account all pertinent facts and circumstances. § 1.6664-4(b)(1). All relevant facts, including the nature of the tax investment, the complexity of the tax issues, issues of independence of a tax advisor, the competence of a tax advisor, and the sophistication of the taxpayer must be developed to determine whether there was reasonable cause and good faith. Generally, the most important factor is the extent of the taxpayer's effort to assess their proper tax liability. Id. See also Larson v. Commissioner, T.C. Memo. 2002-95.

Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Reliance on professional advice constitutes reasonable cause and good faith only if, under all the circumstances, the reliance was reasonable and the taxpayer acted in good faith. Id. In determining whether a taxpayer has reasonably relied on professional tax advice as to the tax treatment of an item, all facts and circumstances must be taken into account. § 1.6664-4(b)(1).

The advice must be based upon how the law relates to the pertinent facts and circumstances. For example, the advice must take into account the taxpayer's purpose (and the relative weight of those purposes) for entering into a transaction and for structuring a transaction in a particular manner. A taxpayer will not be considered to have reasonably relied in good faith on professional tax advice if the taxpayer fails to disclose a fact it knows, or should know, to be relevant to the proper tax treatment of an item. § 1.6664-4(c)(1)(i). The same facts relevant to the substantive issues will bear on the penalty, including the taxpayer's reasons for entering into the Notice 2004-30 transaction.

The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. § 1.6664-4(c)(1)(i). Accordingly, the accuracy of critical assumptions contained in any opinion letter considered.

In any tax shelter transaction, the taxpayer has a duty to fully investigate all aspects of the transaction before proceeding. The taxpayer cannot simply rely on statements by another person, such as a promoter. See Novinger v. Commissioner, T.C. Memo. 1991-289. Moreover, if the tax advisor is not versed in the details of the transaction, mere reliance on the tax advisor does not suffice. See Addington v. United States, 205 F.3d 54 (2d Cir. 2000); Freytag v. Commissioner, 89T.C. 849 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990); Goldman

v. Commissioner, 39 F.3d 402 (2d Cir. 1994); and Collins v. Commissioner, 857 F.2d 1383 (9th Cir. 1988).

Reliance on tax advice may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of the federal tax law. § 1.6664-4(c)(1). For a taxpayer's reliance on advice to be sufficiently reasonable so as possibly to negate a § 6662(a) accuracy-related penalty, the Tax Court stated that the taxpayer has to satisfy the following three prong test: (1) the advisor was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer gave to the advisor the necessary and accurate information; and (3) the taxpayer actually relied in good faith on the advisor's judgment. Neonatalogy Associates P.A. v. Commissioner, 115 T.C. 43 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002).

Generally, if a taxpayer is unwilling to produce a copy of its opinion letter, the taxpayer should not be relieved from penalty consideration. Moreover, an opinion letter prepared by a promoter should not be accorded significant weight. Neonatology Associates, 115 T.C. 43, 98 (2000), aff'd 299 F.3d 221 (3d Cir. 2002) (While good faith reliance on professional advice may establish reasonable cause, "reliance may be unreasonable when it is placed upon insiders, promoters, or their offering materials, or when the person relied upon has an inherent conflict of interest that the taxpayer knew or should have known about."); Goldman v. Commissioner, 39 F.3d 402, 408 (2d Cir. 1994) aff'g T.C. Memo. 1993-480 ("Appellants cannot reasonably rely for professional advice on someone they know to be burdened with an inherent conflict of interest"); Marine v. Commissioner, 92 T.C. 958, 992-93 (1989), aff'd without published opinion, 921 F.2d 280 (9th Cir. 1991). Such reliance is especially unreasonable when the advice would seem to a reasonable person to be "too good to be true." Pasternak v. Commissioner, 990 F.2d 893, 903 (6th Cir. 1993), aff'g Donahue v. Commissioner, T.C. Memo. 1991-181; Gale v. Commissioner, T.C. Memo. 2002-54; Elliott v. Commissioner, 90 T.C. 960, 974 (1988), aff'd without published opinion, 899 F.2d 18 (9th Cir. 1990). § 1.6662-3(b)(2). But see Chamberlain v. Commissioner, 66 F.3d 729, 733 (5th Cir. 1995), aff'g in part and rev'g in part T.C. Memo. 1994-228 (reliance on expert advice from the accountant specified in the shelter offering material was reasonable). If a taxpayer did not obtain a legal opinion from anyone other than the promoter in connection with its Notice 2004-30 transaction, the taxpayer's reliance on the legal opinion may not have been reasonable. In many of the Notice 2004-30 transactions, the taxpayers relied entirely upon a legal opinion from the promoter. In addition, if the taxpayer did not receive the opinion letter until after the return was filed, he/she could not have reasonably relied on the opinion and thus, should not be relieved from penalties.

Special Rule for Tax Shelter Items of Corporations

With respect to reasonable cause for the substantial understatement penalty attributable to tax shelter items of a corporation, special rules apply. A corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but only if there is substantial authority within the meaning of § 1.6662-4(d) for the treatment of the item and the corporation reasonably believed, when the return was filed, that the treatment was more likely than not the proper treatment. § 1.6664-4(f)(2)(i)(A) & (B). Because many corporations rely on the opinion of a tax professional, the opinion should be obtained to determine whether these requirements are met.

Although satisfaction of the "substantial authority" and "belief" requirements is necessary to a reasonable cause finding, this may not be sufficient. For example, reasonable cause may still not exist if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed benefits that were unreasonable in comparison to the initial investment in the tax shelter, or if the taxpayer agreed with the shelter promoter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter. § 1.6664-4(f)(3).

C. Disclosure Initiative under Announcement 2002-2

Accuracy-related penalties will generally be waived for taxpayers that properly disclosed the Notice 2004-30 transactions as part of the Announcement 2002-2 disclosure initiative. As explained in Announcement 2002-2, however, the penalty waiver is not available in situations where the disclosed item had been raised as an examination issue prior to the time when the taxpayer made the disclosure. In addition, the penalty waiver is not available for certain transactions that did not actually occur, transactions that involve fraudulent concealments, and transactions that involve deductions of personal, household, or living expenses.

Settlement Guideline

Whether the accuracy-related penalty applies to underpayments attributable to Notice 2004-30 transactions must be determined on a case by case basis based upon the application of the legal standard for the penalty (as set forth above) to the specific facts and circumstances of each case. Accuracy-related penalties will generally be waived for taxpayers that properly disclosed the Notice 2004-30 transactions as part of the Announcement 2002-2 disclosure initiative.

The accuracy-related penalty has been sustained in the tax shelter area against taxpayers who claim to have reasonably relied on professional advice. In Nicole

Rose Corp., supra, petitioner argued that it had reasonable cause because it relied on qualified advisors concerning an issue of first impression. The trial and appellate courts rejected that argument, finding that the scheme was so clear and obvious that the participation of professionals could not shelter the taxpayer from the penalty. Id. at 341 and 320 F.3d 282, 284-85 (2d Cir. 2002). Similarly, in Long Term Capital Holdings v. United States, 330 F. Supp.2d 122, 205-211 (D. Conn. 2004), aff'd 2005-2 USTC ¶50,575 (2d Cir., Sept. 27, 2005), the court held that a taxpayer had failed to demonstrate that it had relied reasonably and in good faith on advice from a large law firm. See also Neonatology Associates, supra.

Negligence or Disregard of Rules or Regulations

Appeals believes that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. If the facts establish that the claimed deductions from a Notice 2004-30 transaction lacked economic substance, then the accuracy-related penalty attributable to negligence may be applicable if there was no reasonable attempt to ascertain the correctness of the claimed losses or deductions. Taxpayers, who point solely to the opinions of the promoter of the transaction, or a law firm or similar entity associated with the promoter for purposes of the transaction, should not be viewed as having made a reasonable attempt to ascertain the correctness of the income exclusion.

Where a taxpayer can point to an analysis of the tax consequences of the transaction prepared by an independent professional tax advisor that supports its position, or its own contemporaneous analysis where the taxpayer had sufficient knowledge to reasonably believe that it could conduct such an analysis, the taxpayer may have made a reasonable attempt to properly report the transaction.

Substantial Understatement

Appeals believes that Notice 2004-30 transactions will meet the definition of a tax shelter, and that the taxpayers will lack substantial authority for their positions. Accordingly, the accuracy-related penalty will apply in most cases based on a substantial understatement of income tax.

Generally, if a taxpayer is unwilling to produce a copy of its opinion letter, the taxpayer should not be relieved from penalty consideration. Moreover, an opinion letter prepared by a promoter should not be accorded significant weight. Neonatology Associates, supra at 98 (reasoning that while good faith reliance on professional advice may establish reasonable cause, "reliance may be unreasonable when it is placed upon insiders, executives, or their offering materials, or when the person relied upon has an inherent conflict of interest that the taxpayer knew or should have known about.") In addition, if the taxpayer did not receive the opinion letter until after the return was filed, the taxpayer could not have reasonably relied on the opinion and thus should not be relieved from penalties. See Long Term Capital Holdings, supra at 208.

In Long Term Capital Holdings, supra, the court concluded that a legal opinion did not provide a taxpayer with reasonable cause where: (1) the taxpayer did not receive the written opinion prior to filing its tax return, and the record did not establish the taxpayer's receipt of an earlier oral opinion upon which it would have been reasonable for the taxpayer to rely; (2) the opinion was based upon unreasonable assumptions; (3) the opinion did not adequately analyze the applicable law; and (4) the taxpayer's partners did not adequately review the opinion to determine whether it would be reasonable to rely on it. Id. at 205-11. In addition, the court concluded that the taxpayer's lack of good faith was evidenced by its decision to attempt to conceal the losses reported from the transaction by netting them against gains on its returns. Id. at 211-212.

On December 30, 2003, Treasury and the Service amended the § 6664 regulations to provide that the failure to disclose a reportable transaction, on Form 8886, "Reportable Transaction Disclosure Statement," is a strong indication that the taxpayer did not act in good faith with respect to the portion of an underpayment attributable to a reportable transaction, as defined under § 6011. See § 1.6664-4(d). While this amendment applies to returns filed after December 31, 2002, with respect to transactions entered into on or after January 1, 2003, the logic of this provision applies to reportable transactions occurring prior to that effective date. Failure to comply with the disclosure provisions of the law is a strong indication of bad faith.

Appeals believes that litigation hazards with respect to the applicability of the accuracy-related penalty based on a substantial understatement of income tax relate to the facts of each case and development of the issue by the Government.

In determining whether a penalty applies the following factors are relevant: the sophistication of the taxpayer; whether the taxpayer obtained an outside opinion; the contents of any outside opinion; the timing of the receipt of the opinion in relation to the filing of the tax return; whether the opinion was given by an advisor connected with the promotion or promoter in contrast to the taxpayer's regular advisor; whether the promoter arranged for the opinion; the contents of

the opinion; and any efforts to conceal the transaction, mislead the Service, or fail to cooperate in the examination of the transaction. If any of these factors are present, then they should be considered in connection with the assertion or settlement of the penalty raised.

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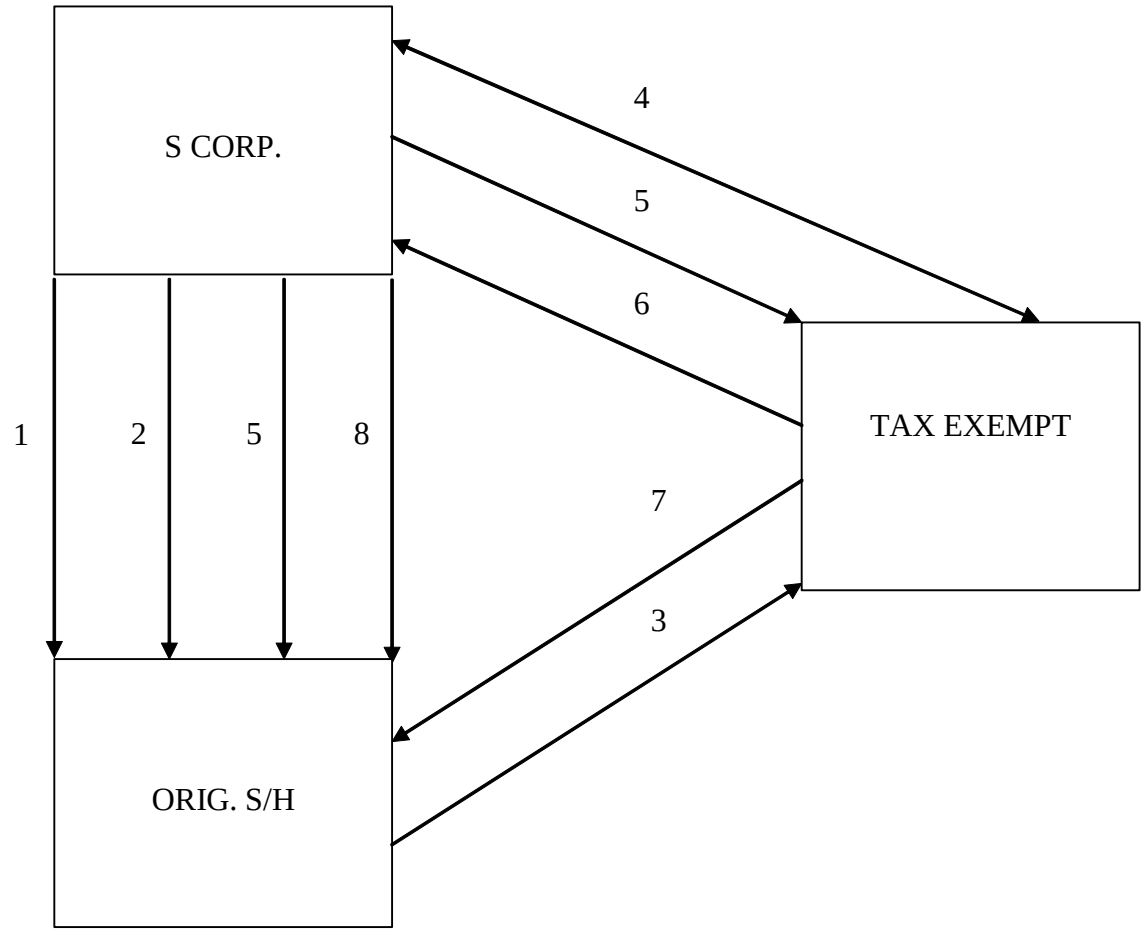
NOTICE 2004-30
DIAGRAM OF THE TRANSACTION



TRANSACTION

Step 1:

The S corporation's Board of Directors authorizes and issues nonvoting stock to the original shareholder. It issues 9 shares of nonvoting stock for every 1 share of voting stock (assume that there are 1,000 shares of voting stock).

Step 2:

The S corporation's Board of Directors authorizes and issues warrants to the original shareholder. It issues 10 warrants for every share of nonvoting stock issued in step 1 above.

Step 3:

The original shareholder transfers the nonvoting stock to the exempt party, and in most cases claims a charitable contribution.

Step 4:

The S corporation and exempt party enter into a redemption agreement to redeem the nonvoting stock in 2 - 3 years.

Step 5:

The S corporation allocates 90% of its income to the exempt party and 10% to the original shareholder. Little or no distributions or dividends are issued during this transaction.

Step 6:

The S corporation redeems the nonvoting stock from the exempt party.

Step 7:

Alternatively, the original shareholder, through a repurchase agreement, buys the nonvoting stock from the exempt party.

Step 8:

After the nonvoting stock is redeemed or repurchased, the S corporation is free to distribute to the original shareholder funds attributable to the 90% income in step 5, above.