Part III. Administrative, Procedural, and Miscellaneous

Renewable Electricity Production Credit, Publication of Inflation Adjustment Factor and Reference Prices for Calendar Year 2004

Notice 2004–29

This notice publishes the inflation adjustment factor and reference prices for calendar year 2004 for the renewable electricity production credit under § 45(a) of the Internal Revenue Code. The 2004 inflation adjustment factor and reference prices are used in determining the availability of the credit. The 2004 inflation adjustment factor and reference prices apply to calendar year 2004 sales of kilowatt-hours of electricity produced in the United States or a possession thereof from qualified energy resources.

BACKGROUND

Section 45(a) provides that the renewable electricity production credit for any tax year is an amount equal to the product of 1.5 cents multiplied by the kilowatt-hours of specified electricity produced by the taxpayer and sold to an unrelated person during the tax year. This electricity must be produced from qualified energy resources and at a qualified facility during the 10-year period beginning on the date the facility was originally placed in service.

Section 45(b)(1) provides that the amount of the credit determined under § 45(a) is reduced by an amount that bears the same ratio to the amount of the credit — as (A) the amount by which the reference price for the calendar year in which the sale occurs exceeds 8 cents, bears to (B) 3 cents. Under § 45(b)(2), the 1.5 cents in § 45(a) and the 8 cents in § 45(b)(1) are each adjusted by multiplying the amount by the inflation adjustment factor for the calendar year in which the sale occurs.

Section 45(c)(1) defines qualified energy resources as wind, closed-loop biomass, and poultry waste. Section 45(c)(3) defines a qualified facility as any facility owned by the taxpayer that originally is placed in service after December 31, 1993 (in the case of a facility using wind to produce electricity), December 31, 1992 (in the case of a facility using closed-loop biomass to produce electricity), or December 31, 1999 (in the case of a facility using poultry waste to produce electricity), and before January 1, 2004. See § 45(d)(7) for rules relating to the inapplicability of the credit to electricity sold to utilities under certain contracts.

Section 45(d)(2)(A) requires the Secretary to determine and publish in the Federal Register each calendar year the inflation adjustment factor and the reference prices for the calendar year. The inflation adjustment factor and the reference prices for the 2004 calendar year were published in the Federal Register on March 25, 2004, (69 Fed. Reg. 15436).

Section 45(d)(2)(B) defines the inflation adjustment factor for a calendar year as the fraction the numerator of which is the GDP implicit price deflator for the preceding calendar year and the denominator of which is the GDP implicit price deflator for the calendar year 1992. The term "GDP implicit price deflator" means the most recent revision of the implicit price deflator for the gross domestic product as computed and published by the Department of Commerce before March 15 of the calendar year.

Section 45(d)(2)(C) provides that the reference price is the Secretary's determination of the annual average contract price per kilowatt hour of electricity generated from the same qualified energy resource and sold in the previous year in the United States. Only contracts entered into after December 31, 1989, are taken into account.

INFLATION ADJUSTMENT FACTOR AND REFERENCE PRICES

The inflation adjustment factor for calendar year 2004 is 1.2230. The reference prices for calendar year 2004 are 3.24 cents per kilowatt-hour for facilities producing electricity from wind energy resources and 0 cents per kilowatt-hour for facilities producing electricity from closed-loop biomass and poultry waste energy resources.

PHASE-OUT CALCULATION

Because the 2004 reference prices for electricity produced from wind, closed-loop biomass, and poultry waste energy resources do not exceed 8 cents per kilowatt hour multiplied by the inflation adjustment factor, the phaseout of the credit provided in § 45(b)(1) does not apply to electricity produced from wind, closed-loop biomass, or poultry waste energy resources sold during calendar year 2004.

CREDIT AMOUNT

As required by § 45(b)(2), the 1.5¢ amount in § 45(a)(1) is adjusted by multiplying such amount by the inflation adjustment factor for the calendar year in which the sale occurs. If any amount as increased under the preceding sentence is not a multiple of 0.1¢, such amount is rounded to the nearest multiple of 0.1¢. Under the calculation required by § 45(b)(2), the renewable electricity production credit for calendar year 2004 is 1.8¢ per kilowatt hour on the sale of electricity produced from wind energy, closed-loop biomass, and poultry waste resources.

DRAFTING INFORMATION CONTACT

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S Corporation Tax Shelter

Notice 2004–30

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

FACTS

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

Shortly after the issuance of the nonvoting stock and the warrants, the original shareholders donate the nonvoting stock to the exempt party. The parties to the transaction claim that, after the donation of the nonvoting stock, the exempt party owns 90 percent of the stock of the S corporation. The parties further claim that any taxable income allocated on the nonvoting stock to the exempt party is not subject to tax on unrelated business income (UBIT) under §§ 511 through 514 (or the exempt party has offsetting UBIT net operating losses). The original shareholders might also claim a charitable contribution deduction under § 170 for the donation of the nonvoting stock to the exempt party. In some variations of this transaction, the S corporation may issue nonvoting stock directly to the exempt party.

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

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

DISCUSSION

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

The Service intends to challenge the purported tax benefits from this transaction based on the application of various theories, including judicial doctrines such as substance over form. Under appropriate facts and circumstances, the Service also may argue that the existence of the warrants results in a violation of the single class of stock requirement of § 1361(b)(1)(D), thus terminating the corporation's status as an S corporation. *See, e.g.*, §§ 1.1361–1(l)(4)(ii) and (iii).

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

Persons who are required to register these tax shelters under § 6111 but have failed to do so may be subject to the penalty under § 6707(a). Persons who are required to maintain lists of investors under § 6112 but have failed to do so (or who fail to provide those lists when requested by the Service) may be subject to the penalty under § 6708(a). In addition, the

Service may impose penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under § 6662.

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

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

Intercompany Financing Using Guaranteed Payments

Notice 2004–31

The Internal Revenue Service and Treasury Department are aware of a type of transaction, described below, in which a corporation claims inappropriate deductions for payments made through a partnership. This notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, and substantially similar transactions, as listed transactions for purposes of § 1.6011–4(b)(2) of the Income Tax Regulations and §§ 301.6111–2(b)(2) and 301.6112–1(b)(2) of the Procedure and Administration Regulations. This notice also alerts parties involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.

FACTS

The transactions described in this notice use a partnership in an attempt to convert interest payments that would not be currently deductible under § 163(j) into deductible payments. One such transaction involves the formation of a partnership (PRS) by a domestic corporation (DC2) and a foreign person (FP). FP is the common foreign parent, or an affiliate of the common foreign parent, of the affiliated group (within the meaning of § 1504(a), but without regard to § 1504(b)(3)) to which DC2 and a second domestic corporation (DC1) belong. In the transaction, FP and DC2 contribute property to PRS. PRS contributes a substantial portion of the contributed assets to DC1 in exchange for preferred stock. Under the partnership agreement, FP is entitled to (1) a substantial guaranteed payment for the use of capital, and (2) a disproportionately small share (relative to FP's capital contribution) of both the gross dividend income from DC1 and PRS's deductions for guaranteed payments. Under the partnership agreement, DC2 is entitled to a disproportionately large share (relative to DC2's capital contribution) of both the gross dividend income from DC1 and PRS's deductions for guaranteed payments.

Each year, DC1 pays substantial dividend income to PRS on the preferred stock. PRS allocates to DC2 the dividend income as well as PRS's deductions for guaranteed payments. If the guaranteed payment right to FP were instead debt of DC1 to FP, then interest on such indebtedness would be subject to the limitations imposed by § 163(j).

DC2 claims, based on its affiliation with DC1 (the corporation paying the dividend), a 100 percent dividends received deduction under § 243(a)(3) for its distributive share of dividend income. In addition, DC2 deducts its distributive share of the guaranteed payment. Consequently, DC2 claims a substantial net deduction.

In one variation of this transaction, PRS has an obligation to make guaranteed payments to a partner (X) unrelated to FP and its affiliates and PRS's obligation to make guaranteed payments to X is assured by a related party, such as FP, in a manner similar to a disqualified guarantee as defined in § 163(j)(6)(D), so as to avoid treatment as disqualified interest under § 163(j)(3)(B).

DISCUSSION

The Service intends to challenge the purported tax benefits of these transactions on various grounds. The Service may treat FP as directly acquiring an equity investment in DC1, because FP and DC2 lack the requisite non-tax business purpose to form a valid partnership. *See ASA Investerings Partnership. v. Commissioner*, T.C. Memo 1998–305, *aff'd*, 201 F.3d 505 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 871 (2000); *Andantech, L.L.C. v. Commissioner*, T.C. Memo 2002–97, *aff'd*, 331 F.3d 972 (D.C. Cir. 2003). The Service also may challenge the transaction under the partnership anti-abuse rule contained in § 1.701–2. In addition, the Service may challenge the purported tax results on the grounds that the allocations under the partnership agreement lack substantial economic effect (as discussed below) and are not in accordance with the partners' interests in the partnership as required by § 704(b).

In particular cases, the Service may argue that the allocations lack economic effect. Alternatively, where the allocations have economic effect, or are deemed to have economic effect, the Service may assert that such economic effect is not substantial. The economic effect of allocations is not substantial if, at the time the allocations became part of the partnership agreement, (i) the after-tax economic consequences to one partner might, in present value terms, have been enhanced compared to such consequences if the allocations had not been contained in the partnership agreement, and (ii) there was a strong likelihood that the after-tax economic consequences of no partner would, in present value terms, have been substantially diminished compared to such consequences if the allocations were not contained in the partnership agreement.

In the example described above, under the partnership agreement, DC2 is entitled to a disproportionately large share of both the gross dividend income from DC1 and PRS's deductions for guaranteed payments. To the extent the dividend income and guaranteed payment deduction offset, this allocation will not alter the economic returns of DC2 and FP compared to their returns if such items were allocated to FP. Neither DC2 nor FP suffers a detriment to its after-tax economic consequences as a result of the special allocations. However, the allocations in the agreement will improve the after-tax consequences to DC2 because a larger share of partnership items will allow DC2 to claim a larger net deduction attributable to the dividends received deduction. The Service may argue, based on this analysis or on other relevant analyses, that the economic effect of the allo-