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ALL INDUSTRIES

S CORPORATION TAX SHELTER
NOTICE 2004-30
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INTRODUCTION

On April 1, 2004, the Internal Revenue Service issued Notice 2004-30, 2004-17 I.R.B. 828, announcing 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 organization while retaining the economic benefits associated with that stock. The purpose of this coordinated issue paper is to discuss the grounds for taxing the proper taxpayers on the income from the corporation's business and disallowing deductions the taxpayers improperly claim as a result of participating in Notice 2004-30 transactions. Examiners should challenge these transactions on the basis of two alternative legal theories, both of which should be asserted. These positions will result in notices of deficiency to both the S corporation shareholders and to the C corporation as a result of the proposed termination of its status under Subchapter S. There are various statutory and judicial bases that may be used to challenge the taxpayer's position, but these arguments must be tailored to the specific facts of the case. Because many of the legal arguments are document sensitive, extensive factual development is necessary for each transaction in order to establish and evaluate the appropriate legal positions.

GROUNDS FOR REATTRIBUTION AND DISALLOWANCE

1. The transfer of the S corporation stock to the exempt party will be disregarded for Federal tax purposes under judicial doctrines. Consequently, 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.

2. Alternatively, 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 and § 1.1361-1(l) of the Income Tax Regulations. The S corporation election will terminate on the date the second class of stock is 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.

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

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

5. 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. For LMSB taxpayers, assertion or nonassertion of penalties must be approved by the Director of Field Operations.

FACTS

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 § 501(a) and is described in either § 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 § 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 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 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 §§ 511 through 514 (or the exempt party has offsetting unrelated business net operating losses). The original shareholders claim a charitable contribution deduction under § 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 exempt parties serve as accommodation parties to facilitate these tax avoidance transactions.

The transaction 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 it.

Development of the cases has uncovered very few facts that are materially different from those described above. As previously noted, in some instances, the transfer of nonvoting stock was made by the S corporation instead of the shareholders. Some of the pledge agreements may have been executed by the S corporation instead of the shareholders. In at least one case, the assets of the S corporation were sold while the exempt party held the nonvoting stock. Ninety percent of the gain from the sale was allocated to the exempt party.

Generally, the exempt parties took no steps to record the transfer of the stock or any aspect of the transaction on their books and did not list the nonvoting shares as assets in their financial reports. The exempt parties only recorded the

transactions when they received cash payments under the redemption agreements or other purchase agreements. A number of the S corporations did 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.

DISCUSSION

1. The transfer of the S corporation stock to the exempt party will be disregarded for Federal tax purposes under judicial doctrines.

The essence of this transaction was not a donative contribution of stock to an exempt party. The primary purpose of the transaction was to reduce S corporation pass-through income to the original shareholders' 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. 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.

A. 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 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). 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.

B. 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).

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 nontax 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 nontax 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 nontax 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 nontax 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 nontax 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 nontax 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 your S Corporation Technical Advisor.

2. Alternatively, the capital structure created in the Notice 2004-30 transaction violates the single class of stock requirement of § 1361(b)(1)(D) and § 1.1361-1(l).

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 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. If you have questions regarding whether the warrants constitute equity or otherwise result in the holder being treated as the owner of stock, please contact your S Corporation Technical Advisor.

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

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.

A. 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.

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.

B. 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 of 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.

C. Substantiation

A charitable contribution deduction is allowable only if substantiated in accordance with regulations prescribed by the Secretary. § 170(a)(1) and (f)(8); 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.

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.

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

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, 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.

5. 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.

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. Accordingly, examination teams should ensure that the scope of factual development encompasses those matters relevant to penalties. A separate report should be prepared for the penalty issue.

The extent of the taxpayer's disclosure must be considered in connection with the application of the accuracy-related penalties. A determination must be made as to whether the disclosure was timely and adequate. Regardless of whether a decision is made to apply penalties, a separate report must be prepared for the penalty issue addressing disclosure or the lack thereof.

The extent of the taxpayer's due diligence in investigating the Notice 2004-30 transaction is an important factor to consider in connection with the accuracy-related penalty, as well as the reasonable cause exception. Facts need to be fully developed to determine when and how the taxpayer found out about the Notice 2004-30 transaction; details of meetings and correspondence with promoter personnel; the identity of advisors to the taxpayer and the type of advice provided; details of internal memorandums, notes, and meetings; the identity of taxpayer personnel that investigated the transaction and/or made the decision to participate; and actions that were taken by taxpayer personnel when the transaction was being considered.

The following factors affecting the consideration of penalties have been present in many of the cases involved in Notice 2004-30 transactions: the promotional materials generally emphasize the tax benefits; taxpayers have been unable to provide a valid non-tax business purpose for the transactions; 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. These factors are not all statutorily required for the penalty. Some of the factors go to the issue of reasonable cause and good faith. Others go to the issue of whether or not the transaction is a tax shelter.

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[1] 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

[1] For purposes of § 6662, the term "underpayment" is generally the amount by which the taxpayer's correct tax is greater than the tax reported on the return. See § 6664(a).

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, 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 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.

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). § 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).

In the case of items of taxpayers, other than corporations, attributable to tax shelters, exception (2) above does not apply and exception (1) applies only if the taxpayer also reasonably believed that the tax treatment of the item was more likely than not the proper treatment. § 6662(d)(2)(C)(i). In the case of items of corporate taxpayers attributable to tax shelters, neither exception (1) nor (2)

above applies. § 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(e) 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.[2] 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.

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 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. The taxpayer may also reasonably rely, in good faith, on the opinion of a professional tax advisor. The opinion must clearly state that, based on the advisor's analysis of the facts and authorities, the advisor concludes that there is a greater than 50 percent chance that the tax treatment will be upheld if the Service challenged the position. § 1.6662-4(g)(4)(A) and (B).

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 and good faith.

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[2] The definition of tax shelter includes, among other things, any plan or arrangement a significant purpose of which is the avoidance or evasion of federal income tax. § 6662(d)(2)(C)(iii).

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, examiners should evaluate the accuracy of critical assumptions contained in any opinion letter.

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 (2000) (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."). 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.[3] § 1.6664-4(f)(2)(i); §§ 1.6664-4(f)(2)(i)(B)(1) & (2). 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

[3] For a discussion of the substantial authority and reasonable belief requirements, see section 5.A.2., supra.

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.