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Subject: IRS Identifies Allegedly Abusive Transactions Involving S Corporations and Charities

Major References: [Notice 2004-30; 2004-17 I.R.B. 1](#)

Prior AALU Washington Reports: 03-23; 99-67; 98-117

MDRT Information Retrieval Index Nos.: 1600.04; 7400.021; 7400.022; 7400.023

The Revenue Service has just identified, in Notice 2004-30, 2004-17 I.R.B. 1, certain transactions as tax avoidance transactions and "listed" transactions under the tax shelter rules. These transactions so identified are between S Corporation shareholders and tax exempt charities and are designed to shift the burden of taxation of S Corporation income to the charities. The disclosure, list maintenance and registration requirements of sections 6011, 6111 and 6112 of the Internal Revenue Code will apply to the transactions as a result of the identifications. (See our Bulletin No. 03-23 for a discussion of the final regulations under these Code sections.)

In our Bulletins Nos. 99-67 and 98-117, we described the basic technique (and risks) of the Charitable Family Limited Partnership (Charitable FLP, also sometimes referred to as a

“CHAR-FLIP”), which has also been discussed in the popular press. In essence, the Charitable FLP involves a gift to charity of a substantial interest (which may be as high as 98%) in a family limited partnership in a manner that arguably entitles the donor to a large tax deduction. The charity’s participation enables the partnership to sell appreciated assets at a small taxable gain. The family-controlled general partner typically receives a 3-10% management fee, and any cash flow that is distributable to the charitable partner during the term of its participation usually is considerably reduced as a result.

After a short period of time, the charity can be expected (but generally is not required) to withdraw from the partnership, receiving a liquidation distribution that is typically much smaller than its nominal percentage ownership. The end result, if all anticipated tax consequences come to fruition, is that the family is left in control of the partnership, having (i) claimed a large tax deduction, (ii) generated a largely sheltered capital gain, and (iii) passed on wealth to family members at little transfer tax cost.

In *Topic G* of its FY 2001 CPE Exempt Organizations Textbook, published in September 2000, the IRS indicated that it regarded the Charitable FLP as raising “a number of potential tax issues.” The article concluded that “[r]eferrals should be made to the Examinations Division if an EO agent identifies an entity holding an interest in a charitable family limited partnership.”

Now, the Internal Revenue Service and the Treasury have announced, in *Notice 2004-30*, that they are aware of a similar type of transaction in which the partnership’s role is filled by an S Corporation.

As described in the Notice, the S Corporation, its shareholders and a tax exempt charity described in section 501(c)(3) of the Code (or a tax-qualified retirement plan maintained by a state or local government) take the following steps:

1. An S corporation issues, pro rata to each of its shareholders nonvoting stock (in, *e.g.*, a ratio of 9 nonvoting shares to 1 voting share) and warrants that are exercisable into nonvoting stock. The warrants may be exercised at any time over a period of years at a strike price that 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. The fair market value of the nonvoting stock is claimed to be substantially reduced because of the existence of the warrants.

2. Shortly after the issuance of the nonvoting stock and the warrants, the original shareholders donate the nonvoting stock to the exempt entity. The parties to the transaction claim that, after the donation of the nonvoting stock, the exempt entity owns 90 percent of the stock of the S corporation. The parties also may claim that any taxable income allocated on the nonvoting stock to the exempt entity is not subject to tax on unrelated business income (or that the exempt entity has offsetting UBIT net operating losses). [Note: Under Code section 512(e), income and gain attributable to S Corporation stock normally would be treated as UBIT to an organization described in section 501(c)(3).] The original shareholders might also claim a charitable contribution deduction for the donation of the nonvoting stock to the exempt entity. In

some variations of this transaction, the S corporation may issue nonvoting stock directly to the exempt entity.

3. Pursuant to one or more agreements entered into as part of the transaction, the exempt entity can require the S corporation or the original shareholders to purchase the exempt entity'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 (or, in some cases, for the fair market value of the stock on the date of donation, if greater).

4. The voting shareholders, who control the amount and timing of any distributions by the S Corporation, exercise that power to cause the S corporation to limit or suspend distributions to its shareholders while the exempt entity purportedly owns the nonvoting stock. However, for tax purposes, during that period, 90 percent of the S corporation's income is allocated to the exempt entity and 10 percent of the S corporation's income is allocated to the voting shareholders.

5. Either (a) the voting shareholders exercise the warrants and dilute the shares of nonvoting stock held by the exempt entity, or (b) the S corporation or the voting shareholders purchase the nonvoting stock from the exempt entity at a value that is substantially reduced by reason of the existence of the warrants. "In either event, the exempt entity 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 entity." (This result is similar to the result purportedly received in the CHAR-FLIP transaction discussed in our earlier Bulletin.)

Notice 2004-30 states that 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". The Notice also states that "[u]nder 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".

In addition, effective April 1, 2004, transactions that are the same as, or substantially similar to, the transaction described in the Notice will be identified as "listed transactions" for purposes of the tax shelter rules of the Code and applicable Treasury regulations. Independent of their classification as listed transactions, transactions that are the same as, or substantially similar to, the transaction described in the Notice may already be subject to the disclosure requirements, the tax shelter registration requirements, or the list maintenance requirements of those rules. Moreover, the exempt entity in the listed transaction also will be treated as a participant in the transaction (whether or not otherwise a participant) for the taxable year of the purported donation, the taxable year of the reacquisition, and all intervening taxable years.

In addition to penalties imposed under the tax shelter rules, the Service may impose other penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty (generally 20% of the amount of an underpayment). Taxpayers who

have already reported these transactions and claimed the benefits described above are advised to amend their returns to disclose them.

Like its predecessor, the CHAR-FLIP, the S Corporation transaction described in the ruling is an aggressive use of the tax exemption of an exempt entity for private purposes. A charity, absent a threat of the loss of its exemption, has little incentive to turn down participation in such schemes because, even if they derived little net benefit, that benefit is greater than zero -- which is what the charity would have received in the absence of the transfer of the stock.

Any AALU member who wishes to obtain a copy of *Notice 2004-30* may do so through the following means: (1) log onto the AALU website at www.aalu.org, enter the *Members Portal* with your social security number and select *Current Washington Report* for linkage to source material; (we are no longer using the Fax-on-Demand system) or (2) write to AALU, Attention DeLane Jones, 2901 Telestar Court, Falls Church, Virginia 22042-1205, and include a reference to this Washington Report No. 04-50.



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