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Warrants and Tax Avoidance Motivation Prove Hazardous

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Corporations are usually subject to Federal income tax, but an important exception is made for "S corporations." The items of income and gain of an S corporation are not, in general, taxed at the corporate level, but, rather, are "passed through" and taxed to its shareholders (whether or not distributions are made to them). There are numerous requirements that a corporation must meet in order to qualify as an S corporation, one of which is that the corporation may have only one class of stock. The Treasury Regulations explain that this "one class of stock" requirement is met only if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.[1]

Under certain circumstances, a right to acquire stock (or another instrument) that on its face is not stock may be characterized as a "second class of stock" for purposes of this requirement, thereby causing the corporation issuing that right (or instrument) to lose its status as an S corporation.[2] However, the Treasury Regulations include exceptions and safe harbors that may permit options and similar interests to be issued on commercially reasonable terms with little or no risk of characterization as stock for this purpose, and taxpayers and their advisors often take advantage of these rules to enable S corporations to develop more flexible capital structures within the framework of the statutory "one class of stock" requirement.

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Santa Clara Valley Housing Group, Inc. v. United States,[3] a recent U.S. District Court decision, is a reminder that, notwithstanding the exceptions and safe harbors in the Regulations, there remains a risk of reclassification of non-stock instruments with an equity flavor, such as warrants, as stock, with potentially disastrous consequences, including loss of S corporation qualification and imposition of a full Federal income tax at the corporate level. This is especially so in circumstances that indicate that the stock right or other instrument was issued as part of a series of transactions bearing an aroma of artificial structuring or tax abuse.

Factual Background

Santa Clara Valley Housing Group, Inc. (Santa Clara) was incorporated in California in May 2000. All of its stock was issued to Stephen Schott, his wife, and their three adult children (collectively, "the Schotts"). Santa Clara elected to be an S corporation in June of the same year.

The accounting firm KPMG had developed what is referred to in the opinion as a "tax shelter product" known as the "S Corporation Charitable Contribution" (or "SC2") strategy, the apparent goal of which was to divert the bulk of the income of an S corporation from its historical (taxable) shareholders to a tax-exempt entity for a period of years. (Since 1998, certain tax-exempt charitable organizations and pension trusts have qualified as S corporation shareholders.) This diversion of income was effected through a "donation" of stock, but the donation and a later repurchase of the shares were structured to cause the historical shareholders to retain most of the economic benefit associated with the income that was allocated to the tax-exempt shareholder.

In order to effectuate the SC2 strategy, Santa Clara was capitalized with the issuance of 1,000 shares of stock to the Schotts, consisting of 100 voting shares and 900 non-voting shares. Santa Clara also issued to each of the Schotts, in June 2000, a warrant to buy ten shares of non-voting stock for each share of non-voting stock held by the shareholder. Although the terms of the warrants and the value of the underlying stock are not discussed in the opinion, one can infer that the exercise of the warrants would have caused the Schotts to own approximately 90% of the value of the equity of the corporation at a cost far less than the anticipated future value of that equity interest.[4]

In July 2000, the Schotts donated all of the outstanding non-voting shares to the City of Los Angeles Safety Members Pension Plan (LAPP), a publicly controlled pension plan for the benefit of retired or injured firefighters and police officers. The Schotts retained the warrants and also had an "understanding" (not further described in the opinion) with the LAPP that the LAPP would sell the shares of non-voting

stock back to the Schotts after a period of time.

Through 2004, Santa Clara reported more than $114 million of ordinary income, of which more than $100 million was allocated to the LAPP as the owner of 90% of the outstanding stock of Santa Clara. No taxes were paid by the LAPP, a tax-exempt entity, on that income.[5] During this period, Santa Clara distributed $202,500 in cash to the LAPP as Santa Clara's majority stockholder. At the end of 2004, the LAPP sold its stock in Santa Clara to the Schotts for $1,645,002.[6] The warrants were never exercised and were canceled in 2006.

The Government's Positions

The Internal Revenue Service audited the tax returns of the Schotts and of Santa Clara, concluded that the series of transactions pursuant to the SC2 strategy constituted an abusive tax shelter, and advanced two alternative theories to tax the income allocated by Santa Clara to the LAPP.[7]

Under one theory argued by the Government (but not developed in the opinion), the SC2 transactions allegedly lacked substance, and the transactions should be recharacterized in such a manner as to reallocate to the Schotts the income that had been allocated by Santa Clara on its tax returns to the LAPP. This theory would have recognized Santa Clara's ongoing qualification as an S corporation.

Under the Government's second theory, however, the warrants constituted a "second class of stock," the issuance of which in June 2000 terminated Santa Clara's status as an S corporation. Thus, Santa Clara would be subject to full Federal corporate income tax, as a regular "C corporation," in 2000 and thereafter.

The IRS issued notices of deficiency to Santa Clara for the year 2000, and to its shareholders for the years 2000 through 2003, asserting additional tax and penalties under these two alternative theories. Santa Clara and one of the shareholders paid the deficiencies asserted and sued for refunds.

Before the district court, the Government and Santa Clara filed cross-motions for summary judgment with respect to the Government's theory that the warrants constituted a second class of stock. In addition, the shareholder filed a motion for summary judgment on her refund claim on the basis that Santa Clara was in fact an S corporation and that its allocations of income to the LAPP were proper and should be given effect.

Second Class of Stock?

The Treasury Regulations governing the treatment of corporate "instruments, obligations, or arrangements" for purposes of the "one class of stock" requirement[8] are, unfortunately, not a model of clarity. The Regulations contain two general rules—one applicable to "any instrument, obligation, or arrangement issued by a corporation," and the other applicable specifically to "a call option, warrant, and similar instrument"—under which an instrument may be treated as a second class of stock.

Under the first rule, an instrument is treated as a second class of stock if (1) 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 (2) a principal purpose of issuing the instrument is to circumvent the rights to distributions or liquidation proceeds conferred by the outstanding shares of stock.

Under the second rule, a call option, warrant, or similar instrument will be treated as a second class of stock if, under the facts and circumstances, it is substantially certain to be exercised and has a strike price substantially below the fair market value of the stock on the date the option is issued. The Regulations do not state explicitly whether the second, more specific rule "preempts the field" with respect to the recharacterization of call options or whether the first, more general rule may also apply to them.

A further ambiguity is introduced by the placement of a safe harbor (the "90% safe harbor") immediately after, and in the paragraph of the Regulations dealing specifically with, the second rule. The safe harbor provides, in relevant part, that a call option will not be treated as a second class of stock if, on the date it is issued, the strike price of the call option is at least 90% of the fair market value of the underlying stock on that date. Just as the Regulations do not specify whether the first, more general rule applies to call options in the first instance, they also do not specify whether this safe harbor would apply to limit the application of the first rule to call options that would otherwise be within its scope.

Santa Clara argued that, because the first rule in the Regulations broadly addressed any "instrument, obligation, or arrangement," while the second rule more narrowly addressed a "call option, warrant, or similar instrument," and because the instrument at issue was – at least in Santa Clara's view—a warrant, only the second rule applied. The court rejected that argument and agreed with the Government that a warrant could potentially be treated as stock under either rule.

The court next concluded that the warrants should be treated as a second class of stock under the first, more general rule. It reasoned that the warrants were designed to preserve the Schotts' beneficial ownership of approximately 90% of the corporation even after the non-voting shares were transferred to the LAPP, by allowing the Schotts to buy from Santa Clara 10 times the number of shares held by the LAPP, if the LAPP refused to sell its shares to the Schotts; and that, accordingly, the warrants could fairly be said to "constitute equity," thereby satisfying the initial prong of the first rule.

The court also had no difficulty in concluding that the warrants met the other prong of the rule, as they were intended to circumvent the rights to distributions and on liquidation that would otherwise be associated with the shares transferred to the LAPP.

The court also evaluated the parties' arguments with respect to the second rule, under which call options in particular may be treated as a second

class of stock. The opinion concludes that the warrants should not be treated as a second class of stock under that rule, because the warrants were not substantially certain to be exercised. Given the court's conclusion as to warrants' constituting stock under the first, general rule, however, the ultimate conclusion in the opinion was that Santa Clara ceased to be an S corporation when the warrants were issued in June 2000.

On that basis, the government—having prevailed on its motion for partial summary judgment here—will presumably seek to recoup from Santa Clara the taxes on its income from and after June 2000.

Observations

While we are generally in agreement with the court's conclusion that warrants and call options are susceptible (in certain circumstances) to being treated as a second class of stock under either of the rules set out in the Regulations and briefly discussed above, we are concerned that the court erred in failing to consider the application of the 90% safe harbor to the warrants at issue in this case. While the 90% safe harbor is physically placed in the Regulations within the paragraphs dealing with the second, more specific rule, it is not by its terms limited to that rule, and, indeed, there is a sentence in an introductory paragraph to this entire portion of the Regulations that strongly suggests that the 90% safe harbor is applicable under both rules.

Moreover, at least some commentators have explicitly noted that they believe that the 90% safe harbor applies as well under the first, more general rule on which the court relied in ruling against Santa Clara.[9] Since it is not apparent that the stipulated facts would have permitted the court to make any determination, in the context of the cross-motions for summary judgment as to the applicability of the 90% safe harbor, the court may have erred in granting summary judgment to the Government.

Given the circumstances as a whole, it is not surprising that the court ruled in the Government's favor. However, the rather brief analysis in the opinion does appear to be open to question in at least one respect, and perhaps will be challenged in further proceedings involving these or other taxpayers.[10]

If the court's order stands as the final determination in this matter, it is to be hoped that the result in the case will be interpreted by the Government and the courts in the context of its particular circumstances, in which warrants were distributed to existing stockholders pursuant to a plan to permit shares of stock to be held by a tax-indifferent party for a defined period and thereby avoid tax on income allocable to those shares—as compared to other contexts in which warrants or other stock options are issued by an S corporation for bona fide business purposes such as to facilitate a loan or to provide incentive compensation for employees.

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1 Reg. § 1.1361-1(l)(1). Differences in voting rights are disregarded in determining whether this requirement is satisfied.

2 *See* Reg. § 1.1361-1(l)(4).

3 Docket no. 5:08-cv-05097 (N.D. Cal., Sept. 21, 2011).

4 *See* footnote 7 and accompanying text below.

5 A pension fund or other "tax-exempt" entity is subject to Federal income tax imposed on its "unrelated business income," a term that includes all items of income passed through to the tax-exempt entity as a shareholder of an S corporation. IRC § 512(e). However, the LAPP may have had losses from one or more other businesses to offset against the income allocated to it by Santa Clara; or it may have taken the position that it was exempt from tax under an "intergovernmental tax immunity" doctrine that precludes the Federal government from taxing certain functions of a State or its political subdivisions. *See generally State of Michigan v. United States*, 74 AFTR 2d 94-6806 (6th Cir. 1994); *see also* IRC § 115.

6 The relatively modest selling price received by the LAPP when it sold its shares of non-voting stock back to the Schotts strongly suggests that the warrants effectively attracted the lion's share of the economic value of the corporation, thereby eviscerating the nominal economic rights of the outstanding shares of stock.

7 During 2004, the IRS announced that it considered the SC2 strategy to be a so-called listed transaction, that it would challenge such transactions on various theories, and that parties participating in such transactions (and potentially other persons assisting in the design and implementation of the transactions) would be subject to onerous reporting and recordkeeping requirements. Notice 2004-30, 2004-1 C.B. 828 (2004). IRC section 4965, added to the Internal Revenue Code in 2006, also deterred the use of SC2 and similar strategies by imposing an excise tax on tax-exempt entities participating in certain tax shelter transactions.

8 *See* footnote 3 above.

9 R. Blau, B. Lemons & T. Rohman, *S Corporations: Federal Taxation*, section 3:53, n. 16 (2011).

10 The opinion notes that "[t]his disposition is not designated for publication in the official reports."

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