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Advisory #162

To: Marketing Partners

Re: Treasury Department Issues Final Tax Shelter Regulations

This Advisory is written to provide you with a general description of the final Tax Shelter Regulations that were recently published by the US Treasury Department.

Executive Summary

The Tax Shelter Regulations are geared to eliminate abusive tax shelters that have no economic purpose other than to avoid tax. The Regulations apply to "Reportable Transactions" that occur on or after February 28th, 2003. The Regulations basically require:

- 1) Taxpayers must **disclose** their participation in "Reportable Transactions" to the IRS.
- 2) Promoters of "Reportable Transactions" must **register** the transaction with the IRS.
- 3) Advisors must **maintain** lists of clients that have entered into "Reportable Transactions".

Failure to complete the required disclosure, registration or maintain client lists will result in very significant penalties to clients, promoters and advisors. While there are numerous types of abusive tax shelters that are covered by these Regulations, certain ESOP arrangements involving "S" corporations have been specifically identified to be abusive tax shelters.

The two most common forms of abusive "S" corporation ESOP arrangements involve certain "management company" schemes and schemes that involve the creation and subsequent sale of hundreds of "S" corporation shell companies. The shell company schemes were an attempt to delay the effective dates of the ESOP "anti-abuse" rules of IRC Sec 409(p). These "anti-abuse" rules were added to the Internal Revenue Code by EGTRRA '01.

A number of various forms of an abusive ESOP scam involving "S" corporation management companies have surfaced over the last several years. One of the more popular versions of abusive ESOP scams that were promoted by certain unscrupulous folks was the "*S Corporation ESOP Management Model*" which we described Advisory #132 dated 7/30/02. Advisory #147 dated 2/20/02 described how Revenue Ruling 2003-6 addressed a number of abusive S corporation ESOP schemes and classified them "*Listed Transactions*". You can access Advisory #132 by clicking <http://www.flpsop.com/bank/132.pdf> and you can access Advisory #147 by clicking <http://www.flpsop.com/bank/147.pdf>.

RevRul 2003-6 significantly increases the already heavy financial penalties for abusive tax shelters. RevRul 2003-6 specifically states that "S" corporation ESOPs that are deemed to be abusive were never qualified plans from their inception. When the "*qualified*" status of an ESOP is lost, all of the claimed tax benefits (corporate income tax deductions for ESOP deposits, 1042 rollover elections, tax exempt growth of ESOP assets, favorable distribution rules, etc) are disallowed.

In addition to losing all of the available tax benefits, significant ERISA penalties for "*prohibited transactions*" can be applied to the sponsoring employer and fiduciaries can be held personally liable. The combination of the penalties that are associated with a "*Listed Transaction*" plus the penalties that result from the "*disqualification*" of an ERISA retirement plan will be financially devastating to those involved.

On April 2nd 2003, Corey Rosen, the Executive Director of The National Center for Employee Ownership, reported on the NCEO's website that in a recent briefing to the Profit Sharing Council of America, the IRS stated that it will be issuing additional guidance in the very near future that will be focused on the various management company scams that were briefly addressed in RevRul 2003-6.

Background

The Tax Shelter Regulations require that taxpaying entities must disclose their participation in what the Regulations define to be "*Reportable Transactions*". Entities that are required to make such disclosure include individuals, trusts, estates, partnerships, limited liability entities and corporations.

There are two types of "*Reportable Transactions*":

- 1) "**Listed Transaction**" - is a transaction that has been specifically identified by the IRS via notice, regulation, revenue ruling, procedure, information release or other form of published guidance. In addition to abusive "S" corporation ESOP scams, "*Listed Transactions*" include but are not limited to certain offshore & domestic trusts, certain offshore credit card schemes, certain IRC Sec 419A(f)(6) welfare benefit plans, certain IRC Sec 412(i) pension plans, certain non-qualified deferred compensation arrangements, certain schemes that shift or increase the tax basis of assets and certain charitable donation schemes.

- 2) "**Confidential Transaction**" - is a transaction that is done under strict terms of confidentiality. All facts & circumstances will be considered when determining whether or not a transaction is a "*Confidential Transaction*". Generally speaking, a "*Confidential Transaction*" is an arrangement where the client's disclosure of the result or structure that is involved is limited in any manner by a written or implied understanding.

To organize the government's effort to curb abusive tax shelters, the IRS has created The Office of Tax Shelter Analysis. It is our understanding that at this point time, there have been about 1,700 disclosures that have been filed with the IRS by about 1,200 taxpayers has resulted in about 80 investigations of promoters of abusive tax shelters.

What to Do If You Have Been Involved In An Abusive ESOP Deal

Since RevRul 2003-6 was issued this past December, we have received inquiries from a dozen or so well meaning Marketing Partners who got involved with

abusive "S" corporation ESOP deals and are now looking for solutions to deal with the problems that have been created.

Unfortunately, there is no way for an ESOP (or any other ERISA plan) to go away quietly. ESOPs must file an annual "5500 Series" tax return with the Department of Labor. There is an ESOP-specific attachment (Schedule ES) that must be attached to the 5500 filing of an ESOP. This schedule is geared to identify general fact patterns that may lead to discriminatory and/or abusive ESOP arrangements. Failure to file an accurate 5500 results in draconian penalties so intentionally filing in inaccurate 5500 will only make matters worse. In addition to annual 5500 filings, in order to properly terminate a qualified retirement plan, there are specific termination procedures that must be observed. Those procedures, if followed, will in all likelihood bring the abusive structure to the light of day and if the prescribed procedures are not followed, it is likely the termination of the ESOP will receive greater scrutiny. Either way, it is highly likely the abusive structure will come to the surface.

The IRS has made it very clear that anyone who tries to hide or ignore "*Reportable Transactions*" is in for a lot of trouble. The accuracy related penalties and excise tax penalties for failure to adhere to the disclosure, registration and filing requirements of "*Reportable Transactions*" are financially devastating.

As a general rule, the IRS can be very accommodating if a taxpayer initiates contact in a good faith attempt to make things right, which is what we strongly suggest be done if you have been involved in an abusive ESOP deal. A great example of how favorable the IRS can treat taxpayers who demonstrate good faith is found in the various "*amnesty*" programs the IRS has for qualified retirement plans.

The "*amnesty*" programs began in the early 1990's and guarantee the continuing qualification of a retirement plan while technical defects or disqualifying events are corrected. In many cases, the IRS has waived or greatly reduced potential penalties as a result of the plan sponsor or fiduciary coming forward to make things right. Conversely, if the IRS discovers a major ERISA problem through its efforts and gets the impression the plan sponsor is trying to mask things over, the IRS will handle things in a much different manner.

It needs to be emphasized the "*amnesty*" programs referred to in the above paragraph are not available to abusive ESOPs. Revenue Ruling 2003-6 specifically

states that an abusive ESOP in an "S" corporation **WAS NEVER** a qualified plan from its inception. Never having been a qualified plan, the ESOP in question would not be eligible for one of the "amnesty" programs as a means to correct the abusive structure.

Epilogue

We would like to take this opportunity to affirm that our *FLPSOP*[®] strategy has always used a "C" corporation platform and the ESOP element always results in a legitimate employee ownership environment that provides meaningful benefits for rank & file employees. It is the strict practice of our firm to work only with legitimate ESOP arrangements that result in meaningful benefits for rank & file employees.

Please be sure to contact Steve, Janet or me if we can be of any help with any client situations that you may have and we will be happy to respond.

Sincerely,

Roland Thon

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