

Office of Chief Counsel
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Memorandum

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to: Mara A. Isumu
Office of Service-wide Interest

from: Julia A. Cannarozzi
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subject: Request for Advice
– Section 6404(g)

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FACTS

The Taxpayer, _____, is challenging the Service's determination that she is not entitled to interest suspension for tax years _____.¹ The Taxpayer believes she qualifies for "interest suspension" under section 6404(g) for each of those years. The Service disallowed a loss reported on her returns from a transaction similar to the distressed asset/debt ("DAD") transaction.² The taxpayer

¹ The Taxpayer's returns for the tax years _____ were filed on _____, respectively.

² The structure of the transaction was as follows: Taxpayer owned 100% of _____, a disregarded entity (DRE). DRE owned a partnership interest in _____ in turn owned a partnership interest in _____. Both _____ and _____ are multi-member limited liability companies treated as partnerships for federal

agreed with the proposed disallowance of the loss and to the imposition of a section 6662 gross-valuation misstatement penalty. The Taxpayer disagrees with the Service determination that she is not entitled to “interest suspension” under section 6404(g) for all _____ years. The Taxpayer’s position is outlined in a _____-page letter dated _____.

. We agree with the Taxpayer that she is entitled to interest suspension for the _____ tax year. However, as discussed below, we do not believe she is entitled to interest suspension for the _____ tax years.

LAW

Generally, interest on underpayments begins to accrue on the date the relevant tax return is due to be filed. In 1998, the section 6404(g)(1) “interest suspension” provisions were enacted (IRS Restructuring and Reform Act of 1998 (RRA) (Pub .L. No. 105-206)). The purpose was to afford some relief to taxpayers from the accrual of interest resulting from unnecessarily prolonged audits. Generally, section 6404(g)(1) provides for the “suspension of interest” where (a) an individual has filed a return on or before the due date for that return, and (b) the IRS has failed to provide notice to the taxpayer specifically stating the taxpayer’s liability and the basis for the liability before the close of the applicable period. I.R.C. § 6404(g)(1). The RRA also included several exceptions that limited the applicability of the suspension (e.g., fraud, criminal penalties, and interest or penalties with respect to any tax liability shown on the return). In 2004, in response to concerns over the use of abusive “tax shelters,” the American Jobs

income tax purposes. _____ reported a loss from the sale of high basis, low value (built-in loss) receivables on each of its returns for _____. The losses flowed through from _____ to _____ and were ultimately claimed on the taxpayer’s _____ returns. After an IRS examination of _____ and _____, the IRS disallowed the losses at the partnership level.

Creation Act of 2004 (AJCA) (Pub. L. No. 108-357) expanded the exceptions. For tax years beginning after December 31, 2003, the interest suspension provisions do not apply to any interest, penalty, addition to tax, or additional amount with respect to any gross misstatement. I.R.C. § 6404(g)(2)(D). In addition, for interest accruing after October 3, 2004, the provisions do not apply to any interest, penalty, addition to tax, or additional amount with respect to any undisclosed reportable transaction or any listed transaction. I.R.C. § 6404(g)(2)(E). The limited suspension of interest that may have been allowed prior to October 3, 2004, was further modified by the Gulf Opportunity Zone Act of 2005 (GOZA) (Pub. L. No. 109-135), effectively repealing the limited interest suspension unless one of the limited exceptions under section 303(a)(2)(B)(ii) thru (iv) of GOZA is satisfied.³

ANALYSIS

A. Exception for Undisclosed Reportable Transactions and Listed Transactions

Pursuant to section 6707A(c)(1), reportable transactions are transactions with respect to which information is required to be included with a return or statement because the Secretary has determined in regulations prescribed under section 6011 that those transactions have a potential for tax avoidance and evasion. I.R.C. § 6707A(c). For purposes of section 6404(g), an undisclosed reportable transaction is a reportable transaction that is not adequately disclosed as provided under Treas. Reg. § 1.6011-4.⁴ For the years at issue, reportable transactions include loss transactions.

³ None of those exceptions apply to this case.

⁴ All references to Treas. Reg. § 1.6011-4 are to those regulations as finalized in T.D. 9046, 2003-1 C.B. 614, effective for transactions entered into on or after February 28, 2003.

See Treas. Reg. § 1.6011-4(b)(5). Taxpayers are required to disclose their participation in reportable transactions by filing a complete Form 8886, Reportable Transaction Disclosure Statement, that describes the transaction, the expected tax treatment, all potential tax benefits expected to result from the transaction, and identifies all of the parties involved. Treas. Reg. § 1.6011-4(d) and the Instructions to Form 8886. If a taxpayer is a partner in a partnership, the taxpayer has participated in a loss transaction if the taxpayer's tax return reflects a flow-through section 165 loss from the partnership equal to \$2 million in a single year or \$4 million in any combination of taxable years. Treas. Reg. § 1.6011-4(b)(5)(i)(C) and (c)(3)(i)(D).

The Taxpayer does not dispute that the underlying transaction is a "loss" transaction and thus a reportable transaction because she reported a section 165 loss in excess of \$2 million on her taxable year return, as well as on her taxable year returns. As a result, the Taxpayer was required to disclose her participation for the tax years . Taxpayer properly disclosed her participation in the transaction on Forms 8886 attached to each of her returns for her taxable years through .⁵ Therefore, the reportable transaction exception to the general rule allowing for "suspension of interest" does not apply for any of those years.

"Listed transactions" are reportable transactions that are the same as, or substantially similar to a transaction specifically identified by the Secretary as a tax

⁵ We assume that copies of the disclosure statements for each year were sent to OTSA as required by Treas. Reg. § 1.6011-4(e)(1).

avoidance transaction for purposes of section 6011.⁶ I.R.C. § 6707A(c)(2). As a type of reportable transaction, listed transactions must also be disclosed as provided by Treas. Reg. § 1.6011-4. However, listed transactions are considered separately from other reportable transactions as an exception to interest suspension because section 6404(g)(2) provides that interest suspension will be disallowed with respect to any undisclosed reportable transaction or any listed transaction. Therefore, any listed transaction, even when that listed transaction is properly disclosed by the taxpayer, fails to qualify for “suspension of interest.” Treas. Reg. § 301.6404-4(b)(5).

Here, the underlying transaction was characterized as a DAD transaction. Though DAD transactions may constitute an abusive transaction, DAD is not a listed transaction. Notice 2008-34, IRB 2008-12 (March 24, 2008), relating to Distressed Asset Trust (DAT) Transactions (in which taxpayers claim a built-in loss through the use of a trust) states that DAD transactions are specifically not identified as listed transactions for purposes of the notice. In addition, DAD transactions are not substantially similar to any other listed transactions. Coordinated Issue Paper – *Distressed Asset/Debt Tax Shelter, LMSB-04-0407-031 (April 18, 2007)*, stated that DAD transactions have been determined not to be substantially similar to Son of Boss transactions. Since the underlying transaction in this case is not considered a “listed transaction” (or substantially similar to one), the exception for listed transactions is not applicable.

B. Exception for Gross Misstatements.

⁶ A complete list of “Listed Transactions” is available on the IRS website.

For tax years beginning after December 31, 2003, interest suspension does not apply to any interest, penalty, addition to tax, or additional amount with respect to any gross misstatement. Gross misstatements for purposes of this section include a gross valuation misstatement within the meaning of section 6662(h)(2)(A) and (B). Treas. Reg. § 301.6404-4(b)(4).

For returns filed prior to August 17, 2006, section 6662(h)(2)(A)(i) provided in relevant part that a gross valuation misstatement arises when the adjusted basis of any property claimed on the return is 400 percent or more of the amount determined to be correct.⁷ The value or adjusted basis of property claimed on a return with a correct value or adjusted basis of zero will be considered to be 400 percent or more of the correct amount. Treas. Reg. § 1.6662-5(g). For passthrough entities (such as partnerships or LLCs treated as partnerships for federal tax purposes), the determination of whether there is a gross valuation misstatement is made at the entity level. Treas. Reg. § 1.6662-5(h)(1). However, the dollar limitation (\$5,000 or \$10,000) is applied at the taxpayer level with respect to the return of the partner. Id.

In Superior Trading, LLC v. Commissioner, 137 T.C. 70 (2011) (appeal pending), US investors claimed losses from a DAD transaction that involved built-in loss assets that were contributed to a US partnership by a tax-indifferent Brazilian retailer. As with the Taxpayer's transaction in this case, the Superior Trading transaction involved a

⁷ For returns filed after August 17, 2006, the threshold in section 6662(h)(2)(A)(i) is only 200 percent of the amount determined to be correct. Based on the filing dates of the Taxpayer's returns, the 200 percent threshold applies to her tax return. However, the distinction is irrelevant as the misstatement on each of the returns satisfies the 400 percent threshold because the correct basis is zero.

series of steps and the use of several layers of partnership structures. The Service (1) disallowed losses claimed from the DAD transaction, (2) adjusted the partnership's basis in the receivables to zero, and (3) asserted the accuracy-related penalty for gross valuation misstatements under section 6662(h). The Tax Court agreed with the Service and collapsed the underlying DAD transaction, determined that the partnership's bases in the assets were zero, and upheld accuracy-related penalties for gross valuation misstatements. Superior Trading, 137 T.C. at 74. The misstatement resulting from the DAD transaction at issue in this case should not be afforded any different treatment than the DAD transaction in Superior Trading, both involve a gross-valuation misstatement under section 6662(h)(2)(A), which constitutes a gross misstatement for purposes of section 6404(g)(2)(D). Treas. Reg. § 301.6404-4(b)(4). It follows that the Taxpayer is not entitled to interest suspension for any interest, penalty, addition to tax, or additional amount for the _____ tax years.

In her _____ letter, the Taxpayer acknowledges the existence of the exception for gross misstatements (see letter at _____). However, without further explanation, the Taxpayer maintains that she made "no gross misstatement on her individual tax return," and concludes that the exception for gross misstatements does not apply to her _____ tax years. We believe that our analysis above is consistent with the plain language of the statute.

CONCLUSION

Taxpayer is entitled to interest suspension for _____ because she properly disclosed her participation in a reportable loss transaction. Taxpayer is not entitled to

section 6404(g) interest suspension for the tax years because the gross misstatement exception applies to both of those years. The exception for gross misstatements was effective only after December 31, 2003 and is not applicable with respect to Taxpayer's tax year.

If you obtain new information from the Taxpayer that requires further analysis, or if you have any questions regarding the advice above, please contact Ms. Julia Cannarozzi at .