

**APPEALS**

**INDUSTRY SPECIALITY PROGRAM**

**SETTLEMENT GUIDELINES**

**INDUSTRY/SPECIALTY AREA:** Abusive Tax Avoidance Transactions

**ISSUE:** Intermediary Transactions Tax Shelters

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**APPROVED:**

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Oct. 15, 2004  
**DATE**

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**Director, Technical Services**

Oct. 15, 2004  
**DATE**

**Effective Date:** Oct. 15, 2004

**SETTLEMENT GUIDELINES  
INTERMEDIARY TRANSACTION TAX SHELTERS  
UIL 9300.16-00**

**STATEMENT OF THE ISSUES**

1. Whether, in intermediary transactions that are the same as or similar to those described in Notice 2001-16, 2001-09 I.R.B. 730 (Intermediary Transaction Tax Shelters), losses and deductions reported by intermediaries are allowable for federal income tax purposes?
2. Whether in Intermediary Transaction Tax Shelters the participation of the intermediary may be disregarded for federal tax purposes so that the transaction may be treated as if either:
  - (a) the target corporation I sold its assets directly to the ultimate buyer Y of the assets and made a liquidating distribution to its shareholder(s) X, or
  - (b) X sold its I stock directly to Y followed by Y's liquidation of I.
3. Whether penalties apply to underpayments attributable to intermediary transaction tax shelters.

**COMPLIANCE POSITION**

On December 19, 2002 the Compliance Industry Specialization Program Coordinated Issue Paper (CIP) on Intermediary Transaction Tax Shelters was approved. Therein the following theories are discussed:

1. The theories upon which the Service will challenge losses and deductions claimed by intermediaries in connection with intermediary transaction tax shelters must be determined on a case-by-case basis depending on the specific facts and circumstances of each case. The Service will disallow such losses or deductions based on the economic substance doctrine and the step transaction doctrine. For a further discussion of those doctrines, see the Lease Stripping Coordinated Issue

Paper dated July 21, 2000, and the Inflated Basis Coordinated Issue Paper dated December 3, 2001. Often, the losses or deductions will not be allowable because, as in Nicole Rose Corp. v. Commissioner, 117 T.C. 328 (2001), aff'd, 230 F.3d 282 (2d Cir. 2003); Andantech L.L.C. v. Commissioner, T.C. Memo. 2002-97, aff'd and rem'd for further proceedings, 331 F.3d 972 (D.C. Cir. 2003) and Long Term Capital Holdings v. United States, \_\_\_ F. Supp. 2d \_\_\_, 2004 U.S. Dist. LEXIS 17159 (D. Conn. August 27, 2004) they relate to transactions that lack business purpose and economic substance. To assist in adequately developing the facts and to ensure that the appropriate theories are identified for pursuit in a particular case, Compliance personnel are encouraged to coordinate with the Compliance Leasing Technical Advisor and to seek the advice of Counsel.

2. Whether an intermediary transaction is properly recast as a direct sale by I of its assets to Y or a direct sale by X of its I stock to Y is a factual issue that depends on the facts and circumstances of the specific intermediary transaction. Until that issue is resolved with respect to a given intermediary transaction, examiners should ensure that the Service's ability to assess deficiencies against each of M, I, and Y is protected.
3. The Service may impose penalties on participants in these transactions, as applicable, including the accuracy-related penalty under section 6662 and the fraud penalty under section 6663.<sup>1</sup>

This Appeals settlement guideline will deal strictly with the issues raised in the Compliance Coordinated Issue Paper, which the Service continues to argue. Appeals Officers, Appeals Team Case Leaders and Appeals Team Managers should consult with the Appeals ISP Coordinator, Corporate Tax Shelters - Leasing Promotions and Intermediary Transaction Tax Shelters, with respect to the issues raised herein. This issue was designated an Appeals Coordinated Issue on March 17, 2004.

## **FACTS**

The parties to the intermediary transaction are X, a seller that desires to sell stock (not the assets) of the target corporation I; M, a corporation that serves as an intermediary that will shelter any income or gain generated in the transaction; and Y, a buyer that desires to purchase the assets (not the stock) of I. Pursuant to a plan, the parties undertake the following steps: X purports to sell the stock of I to M. I then liquidates

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<sup>1</sup> Unless otherwise stated, all section references are to sections of the Internal Revenue Code.

into M, purportedly under section 332.<sup>2</sup> M then sells some or all of the T assets to Y in a transaction that generates gain to M.<sup>3</sup> Y claims a basis in the T assets equal to Y's purchase price.

M typically reports losses and deductions from tax shelters within the meaning of section 6111(c) that offset the gain from the sale of the T assets to Y.<sup>4</sup> The tax shelters frequently include lease stripping transactions and other transactions that purport to create assets with bases that exceed their fair market values.

## **TAXPAYER POSITION**

Taxpayers assert that intermediary transaction tax shelters are arms length transactions that possess economic substance and must be respected for tax purposes. Taxpayers disagree with each of the issues raised herein.

## **DISCUSSION**

Depending upon the facts and circumstances of the case, the Service may raise any one of or combination of issues. The resolution of Intermediary Transaction cases is highly dependent upon the facts and circumstances. The following is a discussion of the legal theories advanced by the Service in the CIP response to Intermediary Transactions.

### **1. Allowability of Losses and Deductions Reported by Intermediary**

The theories upon which the Service will challenge losses and deductions claimed by intermediaries in connection with intermediary transaction tax shelters must be determined on a case-by-case basis depending on the specific facts and circumstances

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<sup>2</sup> In some cases, M merges into T in a reverse merger. This form may be chosen if T had taxable income in prior years against which losses may be carried back in an attempt to obtain refunds of the taxes T paid on that income. See, e.g., Nicole Rose Corp. v. Commissioner, 117 T.C. 328 (2001), aff'd, 230 F.3d 282 (2d Cir. 2003).

<sup>3</sup> In some cases, the assets of T are sold to Y before M acquires T's stock.

<sup>4</sup> In some cases, M may not need to offset the gain from the sale of the T assets. For example, M may be a tax neutral entity.

of each case.<sup>5</sup> Often, the losses or deductions will not be allowable because, as in Nicole Rose Corp. v. Commissioner, *supra*; Andantech L.L.C. v. Commissioner, *supra* and Long Term Capital Holdings v. United States, *supra*, they relate to transactions that lack business purpose and economic substance. When a transaction lacks economic substance, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction. A transaction that is entered into primarily to reduce taxes and that has no economic or commercial objective to support it is a sham and is without effect for federal income tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935); Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Nicole Rose Corp. v. Commissioner, *supra*; ACM Partnership v. Commissioner, 157 F.3d 231, 246-247 (3d Cir. 1998), *aff'g in part and rev'g in part*, T.C. Memo 1997-115, *cert. denied*, 526 U.S. 1017 (1999); United States v. Wexler, 31 F.3d 117, 122 (3d Cir. 1994), *cert. denied*, 513 U.S. 1190 (1995); Andantech L.L.C. v. Commissioner, *supra*.

The economic substance analysis hinges on all of the facts and circumstances surrounding the transaction. No single factor will be determinative. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). Whether a court will respect the taxpayer's characterization of the transaction depends on whether there is a bona fide transaction with economic substance, compelled or encouraged by business or regulatory realities, imbued with tax-independent considerations, and not shaped primarily by tax avoidance features that have meaningless labels attached. Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990), *aff'g sub nom.*, Sturm v. Commissioner, T.C. Memo. 1987-625; Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254 (1999), *aff'd* 254 F.3d 1313 (11<sup>th</sup> Cir. 2001).

An evaluation of whether the transaction lacked economic substance requires a review of separate, but interrelated inquiries: (1) a subjective inquiry into whether the transaction was carried out for a valid business purpose; and (2) an inquiry into the objective economic effect of the transaction. Nicole Rose Corp. v. Commissioner, *supra*; Kirchman v. Commissioner, 862 F.2d 1486, 1490-1492 (11<sup>th</sup> Cir. 1989), *aff'g*, Glass v. Commissioner, 87 T.C. 1087 (1986).

To satisfy the business purpose inquiry, the transaction must be "rationally related to a

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<sup>5</sup> The Lease Stripping Coordinated Issue Paper, (July 21, 2000), addresses theories upon which the Service will challenge deductions reported from lease stripping transactions. The Losses Reported from Inflated Basis Assets from Lease Stripping Transactions Coordinated Issue Paper, (December 3, 2001), addresses theories upon which the Service will challenge losses and deductions from assets with bases traceable to lease stripping transactions.

useful nontax purpose that is plausible in light of the taxpayer's conduct and...economic situation." See Kirchman, supra at 1490-1491.

To satisfy the objective economic inquiry, the transaction must appreciably affect the taxpayer's beneficial interest, absent tax benefits. Knetsch v. United States, 364 U.S. 361, 366 (1960); ACM Partnership v. Commissioner, supra at 248. Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. Knetsch v. United States, supra. Modest or inconsequential profits relative to substantial tax benefits are insufficient to imbue an otherwise questionable transaction with economic substance. ACM Partnership, supra at 258; Sheldon v. Commissioner, 94 T.C. 738, 767-768 (1990). In conducting this economic review, it is appropriate to focus on the taxpayer's calculations at the outset of the transaction. ACM Partnership v. Commissioner, supra at 257.

In Andantech L.L.C. v. Commissioner, supra, the Tax Court disallowed deductions from a taxpayer's involvement in a lease stripping transaction. The taxpayer had acquired an interest in a partnership in a purported section 351 transaction, claimed a carry-over basis, and took depreciation deductions passed through from the partnership. The partnership held depreciable property whose income stream was stripped to an unrelated third party in return for a lump sum payment that was then allocated to a tax neutral entity, prior to the purported section 351 transaction. The Tax Court based its holding upon the following theories: 1) The partnership was a sham; 2) the participation of the initial partners was disregarded under the step transaction doctrine; and 3) the sale-leaseback lacked economic substance.

In addition, the Tax Court addressed alternative theories for disallowing the deductions. The Tax Court posited that, assuming the transaction did not lack economic substance, petitioners would still not be entitled to the depreciation because there was no true sale and the seller financing did not constitute bona fide debt.

On appeal, the D.C. Circuit agreed that the parties never intended to join together as partners to run a business and that the partnership had no legitimate non-tax purpose. As a result, it affirmed the Tax Court's holding that the Andantech partnership should be disregarded for tax purposes and remanded the other issues for further proceedings consistent with its opinion.

In Nicole Rose Corp. v. Commissioner, supra, representatives of Loral Aerospace Corp. (Loral) and Quintron Corp. (Quintron) were negotiating Loral's purchase of Quintron. Loral wanted to purchase the assets of Quintron. Quintron wanted Loral to

instead purchase the stock of Quintron. Intercontinental Pacific Group, Inc. (IPG), facilitated the transaction by causing its dormant shell subsidiary QTN Acquisition, Inc. (QTN) to purchase the stock of Quintron. QTN then merged into Quintron, which sold its assets to Loral.<sup>6</sup> The sale resulted in income to Quintron of approximately \$11 million and produced cash to repay most of the loan that QTN had taken to purchase the Quintron stock.<sup>7</sup> In the same month as the sale, Quintron obtained from an accommodation party an interest that included, among other things, an obligation to make lease payments, an interest in a trust fund that offset the obligation to make lease payments, and the right to receive lease payments that might be due on leased property during a 4-year renewal period under the terms of a “residual value certificate” (RVC). On the same day it acquired the interest, Quintron transferred it (minus the RVC) to a bank. As is explained in the Tax Court opinion, Quintron reported an approximately \$22 million ordinary business expense deduction from the transfer to the bank. The deduction offset Quintron’s \$11 million of income from its asset sale to Loral and resulted in Quintron reporting a net operating loss which it carried back to earlier years to produce refunds for those years.

The Tax Court stated that the complicated nature of the transactions “fails to mask the lack of business purpose and economic substance in key aspects of the transactions and the tax avoidance objectives thereof.” *Id.* at 117 T.C. 338. The Tax Court found that the RVC was worthless. *Id.* Moreover, the Tax Court found that the intermediary, Quintron, “never had any genuine obligation with respect to the [interest in the trust fund and the offsetting obligation to make lease payments]” and that its sole purpose for engaging in the same day acquisition and transfer of the interests was to create the claimed tax deductions. *Id.* The Tax Court explained that the interest in the trust fund and the obligation to make lease payments “created essentially a circular flow of funds” so that no money was actually changing hands. *Id.* at 339. As a result, the Tax Court reasoned that the “petitioner had no legitimate interest of value in the trust fund and no legitimate obligations associated therewith.” *Id.* The Tax Court concluded that the petitioner’s claimed tax deductions constituted “merely a tax ploy, a sham, without business purpose and without economic substance.” *Id.* at 340. The transactions were therefore to be disregarded for federal income tax purposes. The Tax Court’s holding was upheld by the Second Circuit. See *Nicole Rose Corp. v. Commissioner*, supra.

In *Long Term Capital Holdings v. United States*, supra, the court found that a

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<sup>6</sup> Quintron’s name was later changed to Nicole Rose Corp.

<sup>7</sup> The balance of the loan was offset by Quintron accounts receivable that were not transferred to Loral.

transaction from which the taxpayer reported a \$106 million deduction from the sale of preferred stock that originated from lease stripping transactions lacked economic substance. The court concluded that the taxpayer had no business purpose for engaging in the transaction other than tax avoidance and that the transaction itself had no economic substance beyond the creation of tax benefits given that the taxpayer “could not have had any realistic or reasonable expectation that it would make a non-tax based profit” from it. The Court rejected the taxpayer’s reliance on United Parcel Serv. of Am. v. Commissioner, 254 F. 3d 1014 (11<sup>th</sup> Cir. 2001). In that case the 11<sup>th</sup> Circuit determined that an internal restructuring of an ongoing business had a business purpose. In contrast, the court reasoned that the transaction in Long Term Capital Holdings was a one-time purchase of a tax product by the taxpayer “that would not have occurred, in any form, but for tax-avoidance reasons.”

In ACM Partnership v. Commissioner, *supra*, the Tax Court found that the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. The Tax Court further stated that the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. It held that the transactions lacked economic substance and, therefore, the taxpayer was not entitled to the claimed deductions. The opinion demonstrates that the Tax Court will disregard a series of otherwise legitimate transactions, where the Service is able to show that the facts, when viewed as a whole, have no economic substance.

The CIP concludes that the transactions outlined above, taken as a whole, have no business purpose independent of tax considerations. Because M's sole purpose was to act as an accommodating party for X and Y and absorb corporate level gain that it planned to offset with losses and deductions, the transactions should be disregarded for federal income tax purposes.

## **2. Treatment of M as a Conduit and Recharacterization of Transaction**

As set forth in Notice 2001-16, 2001-9 IRB 730, several factors typically present in these intermediary transactions support treating M as a mere conduit. First, as set forth above, M will have no business purpose for engaging in the transaction except for facilitating X's stock sale and Y's asset purchase and sheltering the inherent gain on T's assets. Generally M will be either formally or informally required to transfer the T assets to Y after purchasing the T stock. Thus, the asset transfer typically will occur shortly after the stock sale and will be at a predetermined price that was negotiated by X and Y (and possibly T) prior to the stock sale. See Nicole Rose Corp. v. Commissioner, *supra*. Additionally, in many cases, X or Y may indemnify M from any



tax liability. In essence, M never controls T's stock or assets and does not enjoy the normal benefits and burdens of ownership. See Murry v. Commissioner, T.C. Memo. 1984-670. Second, as in Nicole Rose, M often will not be using its own funds to finance the transaction. Rather, M may be relying on financing from a third party lender who will be repaid within a short period of time because the two legs of the transaction will occur within a short time period from one another. This financing often will be arranged or possibly provided by X or Y to help facilitate the transaction. Third, M will be paid a fee, directly or indirectly,<sup>8</sup> for its participation and permitting X and/or Y to benefit from the use of its tax status in the transaction. Fourth, there often are promoters involved in structuring the transaction. Finally, M's participation in these transactions often may provide benefits that may not be achieved in a section 338(h)(10) election. For instance, X may have a high stock basis but T may have a low inside basis in its assets so that a stock sale by X would produce less gain than an asset sale by T. Further, this intermediary transaction often may be used by taxpayers not eligible to make a section 338(h)(10) election (e.g. T is a C corporation with individual shareholders). These facts may also support the use of the step transaction doctrine to disregard M's participation in the transaction. See Andantech L.L.C. v. Commissioner, *supra* (applying the step transaction doctrine to disregard an entity that acted as a mere shell or conduit to strip income from a transaction in an attempt to avoid taxation). In Long Term Capital Holdings, *supra*, the court determined the end result test of the step transaction doctrine applied where there was evidence that the steps in the transaction were prearranged. In reaching its decision, the court emphasized that where a finding of fact can be reached that the steps were prearranged to achieve a particular end result, the steps in the transaction may be collapsed.

The substance of M's participation in the transaction is to serve as a conduit and shelter the gain associated with the sale of T's assets for a fee. In Commissioner v. Court Holding, 324 U.S. 331 (1945), the Supreme Court addressed intermediary arrangements. The Court recognized that conduits may be disregarded in determining the true substance of a transaction by providing that:

The incidence of taxation depends upon the substance of a transaction.  
The tax consequences which arise from gains from a sale of property are  
not finally to be determined solely by the means employed to transfer

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<sup>8</sup> In Nicole Rose Corp. v. Commissioner, *supra*, the intermediary was able to use the purported losses from the leases to not only offset all of the gain from the sale of the assets, but also carried the loss back to prior years of Quintron and received approximately \$2 million in refunds.

legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. *Id.* at 334.

Several authorities have focused on the substance of the transaction in determining how a transaction should be treated for federal income tax purposes. See Estate of Kluener v. Commissioner, 154 F.3d 630 (6<sup>th</sup> Cir. 1998).<sup>9</sup> In Davis v. Commissioner, 88 T.C. 122 (1987), a bank's foreclosure on partnership property and the bank's subsequent sale of the property to another partnership related to the first partnership pursuant to an understanding between the bank and the first partnership was treated as an indirect sale by the first partnership to the related partnership. See also Del Commercial Properties, Inc. v. Commissioner, 54 T.C. 1305 (1970); West Coast Marketing Corp. v. Commissioner, 46 T.C. 32 (1966); and Rev. Rul. 70-140, 1970-1 C.B. 73.

In some instances, M may retain some of the I assets in an attempt to have the form of the transaction respected. This attempt should fail if the retained assets are directly or indirectly returned to X, transferred to Y, or serve as part or all of M's fee for serving as a conduit. If the retained assets are viewed as a payment of a fee to M for its participation in the transaction, depending on the facts and circumstances, this payment may be treated as being made by I, by I on behalf of X (which would be treated as a distribution by I of such assets to X followed by X's transfer of those assets to M as payment of the fee), or by Y. Alternatively, to the extent M retains some of I's assets and such retention is not viewed as a payment of a fee, I should be viewed as directly selling such assets to M. Consequently, M still should be viewed as a mere conduit with respect to the rest of the transaction with I being treated as directly selling its assets (except for the assets sold to M) to Y.

#### A. *Substance of Transaction as an Asset Sale*

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<sup>9</sup> In Estate of Kluener v. Commissioner, 154 F.3d 630 (6<sup>th</sup> Cir. 1998), the taxpayer's contribution of property to his controlled corporation followed by the corporation's sale of property at a gain (that was offset by losses) and subsequent distribution of the sale proceeds to the taxpayer was treated as a direct sale by taxpayer of the property. The corporation was treated as a mere conduit.

In order to determine the characterization of the transaction as an asset or stock sale, all the facts and circumstances of a particular case must be examined.

In some instances, the facts and circumstances of the transaction may favor recasting the transaction so that T is treated as selling its assets directly to Y followed by T's distribution of its assets (including the asset sale proceeds) to X in liquidation.

Some facts that may indicate an asset sale recast include (i) X and Y originally negotiated the transaction as an asset sale, (ii) X introduced M into the transaction, (iii) X is responsible for compensating M for its participation in the transaction, (iv) X agrees to indemnify M and/or Y for any federal tax liability that may result from the transaction, (v) X arranges financing for M to effectuate the transaction, and (vi) X received a greater tax benefit than Y from M's participation in the transaction.

Under this recast, T will recognize the gain on the sale of its assets which will result in a corresponding federal tax liability to T. Additionally, to the extent that T is treated as distributing to X unwanted assets (including deemed distributions of unwanted assets to X so that X may pay M's fee) in liquidation, and T's liquidation into X does not qualify for section 332 treatment, T will recognize gain on such distribution. However, because T has in substance divested itself of the assets needed to pay its taxes by distributing those assets in liquidation to X in the form of the stock sale proceeds and possibly unwanted assets, as discussed below, X generally will be responsible for T's unpaid tax liability as a transferee.

Section 6901 provides a procedure whereby the Service can assess income taxes owing from a delinquent taxpayer against a person to whom the taxpayer has transferred its assets in such a manner as to render itself incapable of satisfying its own income tax obligations. Section 6901(h) defines a transferee as including a distributee and Treas. Reg. §301.6901-1(b) makes clear that the shareholder of a dissolved corporation is a transferee. The determination of whether transferee liability can be imposed on X as a distributee shareholder is dependant on principles governing the rights of creditors as determined by applicable state law. A court generally will focus on the substance of the transaction in making its determination whether transferee liability will be imposed. See Owens v. Commissioner, 64 T.C. 1 (1975) (taxpayer's sale of all of the stock in his wholly owned Subchapter S corporation not respected for transferee liability purposes; taxpayer treated as receiving the assets of the corporation as a transferee and held liable for any deficiency in income taxes of the corporation). Therefore, if the substance of the transaction is an asset sale by T followed by a liquidating distribution of its assets to X, X generally will be responsible for T's unpaid tax liability as a transferee under the applicable state law.

## *B. Substance of Transaction as a Stock Sale*

Alternatively, in some instances the facts and circumstances of the transaction may favor recasting the transaction so that X is treated as selling its stock directly to Y followed by T's distribution of its assets to Y in liquidation. This does not result in tax liability on an asset sale, but denies Y a fair market value basis in the assets.

Some facts that may indicate a stock sale recast include (i) X and Y originally negotiated the transaction as a stock sale, (ii) Y introduced M into the transaction, (iii) Y is responsible for compensating M for its participation in the transaction, (iv) Y agrees to indemnify M and/or X for any federal tax liability that may result from the transaction, (v) Y arranges financing for M to effectuate the transaction, and (vi) Y received a greater tax benefit than X from M's participation in the transaction.

If the substance of the transaction is a stock sale recast and T's liquidation into Y qualifies as a section 332 liquidation, T generally will not recognize any gain or loss on the liquidating distribution under section 337(a) and Y will take a carryover basis in T's assets under section 334(b)(1). Consequently, adjustments may be required to Y's tax return(s) to reflect Y's carryover (rather than fair market value) basis in T's assets. These adjustments may result from Y taking larger depreciation and amortization deductions than would be permitted if a carryover (rather than a fair market value) basis in T's assets were used to calculate such deductions. Additionally, adjustments may result from Y reporting less or no gain (or loss) with respect to sales of T's assets in which Y measured its gain or loss on the sale of T's assets using a fair market value (rather than a carryover) basis in such assets.

The CIP concludes that, in a minority of cases, T's distribution of its assets to Y may not qualify as a section 332 liquidation, and T will be taxable at the corporate level on the distribution of its assets under section 336 and Y will be taxable at the shareholder level under section 331. To the extent T has an unpaid federal tax liability resulting from its distribution of assets to Y in liquidation, Y generally will be liable with respect to such liability as a transferee.

Finally, to the extent T is treated as distributing (or selling) unwanted assets to X or selling (or paying a fee with) unwanted assets to M and recognizing gain, Y generally will be liable with respect to the tax liability resulting from such gain as a transferee.

## **3. Applicability of Penalties**

Whether penalties apply to underpayments attributable to the disallowance of losses

and deductions claimed by intermediaries 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 upon a comparison of the facts developed with the legal standard for the application of the penalty. Compliance teams should accordingly ensure that the scope of their factual development encompasses those matters relevant to penalties. One important issue relevant to the potential assertion of the accuracy-related penalty attributable to a substantial understatement is whether the transaction constitutes a tax shelter as defined in section 6662(d)(2)(C)(iii). The transaction will constitute a tax shelter if a significant purpose of the transaction is the avoidance or evasion of federal income tax (if the transaction was entered into before August 6, 1997, a "principal purpose" standard applies). If the transaction is a tax shelter, then, as explained below, the requirements of Treas. Reg. §1.6662-4(e)<sup>10</sup> should be carefully scrutinized to determine whether a corporate taxpayer had "reasonable cause" sufficient to avoid the accuracy-related penalty attributable to a substantial understatement. If the transaction is not a tax shelter, then Treas. Reg. §§1.6664-4(a) through (d) apply in determining whether a corporate taxpayer had reasonable cause sufficient to avoid the accuracy-related penalty. If the transaction lacks economic substance, the position should be that the principal purpose of such transaction is the avoidance of Federal income tax and the transaction constitutes 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 attributable to, among other things: (1) negligence or disregard of rules or regulations, (2) any substantial understatement of income tax, and (3) any substantial valuation misstatement under chapter 1. Treas. Reg. § 1.6662-2(c) provides that there is no stacking of the accuracy-related penalty components. Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20 percent (40% 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 valuation misstatement). The accuracy-related penalty provided by section 6662 does not apply to any portion of an underpayment on which a penalty is imposed for fraud under section 6663. I.R.C. § 6662(b).

##### 1. Negligence or Disregard of Rules or Regulations

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<sup>10</sup> For transactions entered into after January 1, 2003, see Treas. Reg. § 1.6664-4(f), as contained in 26 CFR part 1, revised April 1, 2003. See Treas. Reg. § 1.6664-1(b)(2)(ii) for the rule on effective dates. Note that former Treas. Reg. § 1.6664-4(e) is identical to current §1.6664-4(f).

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 I.R.C. § 6662(c) and Treas. Reg. § 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, 506 (5th Cir. 1967), aff'g, 43 T.C. 168 (1964). Treas. Reg. § 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. If the facts establish that the intermediary reported losses from a transaction that lacked economic substance or the asset purchaser or the original shareholders brought in the intermediary for the sole purpose of absorbing the corporate level tax, then the accuracy-related penalty attributable to negligence may be applicable if there was no reasonable attempt to ascertain the correctness of the claimed losses or deductions.

A return position that has a reasonable basis is not attributable to negligence. Treas. Reg. § 1.6662-3(c). A reasonable basis is a relatively high standard of tax reporting, one significantly higher than not frivolous or not patently improper. Thus, the reasonable basis standard is not satisfied by a return position that is merely arguable or colorable. Conversely, under Treas. Reg. § 1.6662-3(b)(3), a return position is reasonable where based on one or more of the authorities listed in Treas. Reg. § 1.6662-4(d)(3)(iii), taking into account the relevance and persuasiveness of the authorities and subsequent developments, even if the position does not satisfy the substantial authority standard defined in Treas. Reg. § 1.6662-4(d)(2).

The phrase "disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. The term "rules and regulations" includes the provisions of the Internal Revenue Code and revenue rulings or notices issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-3(b)(2). Therefore, if the facts indicate that a taxpayer took a return position contrary to any published notice or revenue ruling, the taxpayer may be subject to the accuracy-related penalty for an underpayment attributable to disregard of rules and regulations, if the return position was taken subsequent to the issuance of notice or revenue ruling. A disregard of rules or regulations is "careless" if the taxpayer does not exercise reasonable diligence in determining the correctness of a position taken on its return that is contrary to the rule or regulation. A disregard is "reckless" if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances demonstrating a substantial deviation from the standard of conduct observed by a reasonable person. Additionally, disregard of the rules and

regulations is “intentional” where the taxpayer has knowledge of the rule or regulation that it disregards. Treas. Reg. § 1.6662-3(b)(2).

The accuracy-related penalty for disregard of rules and regulations will not be imposed on any portion of underpayment due to a position contrary to rules and regulations if: (1) the position is disclosed on a properly completed Form 8275 or Form 8275-R (the latter is used for a position contrary to regulations) and (2), in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation. This adequate disclosure exception applies only if the taxpayer has a reasonable basis for the position and keeps adequate records to substantiate items correctly. Treas. Reg. § 1.6662-3(c)(1). Further, a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits. Treas. Reg. § 1.6662-3(b)(2).<sup>11</sup>

Taxpayers participating in or filing returns claiming tax benefits from, Intermediary Transaction Tax Shelters transactions after the issuance of Notice 2001-16, on February 26, 2001, took positions contrary to a notice and would be subject to an accuracy-related penalty for disregarding a rule. For Intermediary Transaction Tax Shelter transactions predating the issuance of Notice 2001-16, a taxpayer could be liable for the negligence penalty based upon a 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.

## 2. Substantial Understatement of Tax

A substantial understatement of income tax exists for a taxable year if the amount of the 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). I.R.C. § 6662(d)(1). An understatement is the excess of the amount of the tax required to be shown on the return for the taxable year, over the amount of tax imposed which is shown on the return, reduced by any rebate. I.R.C. § 6662(d)(2)(A). Understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was

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<sup>11</sup> Amendments to the regulations modified these rules for transactions entered into after January 1, 2003, reported on returns filed after December 31, 2003. Under the amendments, a taxpayer may raise the disclosure defense for a reportable transaction only if the taxpayer also disclosed as required under the section 6011 regulations. Also, the defense based on a realistic possibility of success on the merits does not apply of the transaction is a reportable transaction.

substantial authority for such 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. I.R.C. § 6662(d)(2)(B). In the case of items of corporate taxpayers attributable to tax shelters, neither exception (1) nor (2) in section 6662(d)(2)(B), reduction for understatement due to position of taxpayer or disclosed item, applies. I.R.C. § 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 understatement unless the reasonable cause exception applies. See Treas. Reg.

§ 1.6664-4(f) for special rules relating to the definition of reasonable cause in the case of a tax shelter item of a corporation. For transactions entered into before August 6, 1997, the relevant standard was whether tax avoidance or evasion was the "principal purpose" of the entity, plan, or arrangement. Treas. Reg. § 1.6662-4(g)(2)(i). If the facts establish that an understatement attributable to the disallowance of losses or deductions from assets with bases traceable to lease stripping transactions 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), the accuracy-related penalty may apply.

### 3. Substantial or Gross Valuation Misstatement

For the accuracy-related penalty attributable to a substantial valuation misstatement to apply, the portion of the underpayment attributable to a substantial valuation misstatement must exceed \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company). I.R.C. § 6662(e)(2). A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such value or adjusted basis. I.R.C. § 6662(e)(1)(A). If the value or adjusted basis of any property claimed on a return is 400 percent or more of the amount determined to be the correct amount of such value or adjusted basis, the valuation misstatement constitutes a "gross valuation misstatement." I.R.C. § 6662(h)(2)(A). If there is a gross valuation misstatement, then the 20% penalty under section 6662(a) is increased to 40%. I.R.C. § 6662(h)(1). One of the circumstances in which a valuation misstatement may exist is when a taxpayer's claimed basis is disallowed for lack of economic substance. Gilman v. Commissioner, 933 F.2d 143 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992). Thus, where an Intermediary Transaction Tax Shelter involves a loss reported from an inflated with a reported basis of 200 percent or more of the correct amount, an accuracy-related penalty for a substantial or gross valuation misstatement may apply. See Long Term Capital Holdings v. United States, supra (sustaining penalties for gross and substantial valuation misstatements).



## *B. The Fraud Penalty*

Section 6663 imposes a penalty for fraud in an amount equal to 75 percent of the portion of the underpayment that is attributable to fraud. Fraud is established if it is shown that a taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of such taxes. Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983). Once fraud is established for any portion of an underpayment, the entire underpayment is considered fraudulent unless the taxpayer proves otherwise by a preponderance of the evidence. I.R.C. § 6663(h). Knowingly understating income by overstating basis can constitute evidence of fraud. Slaughter v. Commissioner, T.C. Memo. 1954-58 (holding that fraud existed with respect to return on which taxpayer had reported a loss by overstating basis of asset sold); Smith v. Commissioner, T.C. Memo. 1992-353 (holding that fraud existed with respect to return on which taxpayer had overstated basis of asset for depreciation and investment tax credit purposes), aff'd without published opinion, 993 F.2d 1539 (4th Cir. 1993). The existence of fraud is a question of fact to be resolved based on the entire record. Mensik v. Commissioner, 328 F.2d 147, 150 (7th Cir. 1964), cert. denied, 379 U.S. 827 (1964); Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), aff'd without published opinion, 578 F.2d 1383 (8th Cir. 1978). Fraud is never presumed and must be proven by clear and convincing evidence. Stone v. Commissioner, 56 T.C. 213, 220 (1971), acq. in result, 1972-2 C.B. 3; Beaver v. Commissioner, 55 T.C. 85, 92 (1970). Fraud may, however, be proven by circumstantial evidence and, as a result, a taxpayer's entire course of conduct can be considered in determining whether fraud exists. Rowlee v. Commissioner, supra. See also Stone v. Commissioner, supra at 223-24.

Facts establishing that a taxpayer attempted to conceal or mislead, such as by deliberately mislabeling an item, incorrectly reporting the relevant facts, or reporting an item so as to reduce the likelihood that it would be identified for examination, can constitute evidence of fraud. Spies v. United States, 317 U.S. 492, 499 (1943). Similarly, implausible or inconsistent explanations of behavior are an indicia of fraud. Grosshandler v. Commissioner, 75 T.C. 1, 20 (1980). If the factors discussed above are present, then the fraud penalty may be applicable.

## *C. The Reasonable Cause Exception*

The accuracy-related penalty and fraud penalty do not apply 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. I.R.C. § 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. Treas. Reg. §§ 1.6664-4(b)(1) and (f)(1). Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. See Treas. Reg. § 1.6664-4(b). See also Larson v. Commissioner, T.C. Memo. 2002-295.

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, the sophistication of the taxpayer, and the quality of an opinion, must be developed to determine whether the taxpayer was reasonable and acted in good faith.

Circumstances that may suggest reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the facts, including the experience, knowledge, sophistication and education of the taxpayer. The taxpayer's mental and physical condition, as well as sophistication with respect to the tax laws, at the time the return was filed, are relevant in deciding whether the taxpayer acted with reasonable cause. See Kees v. Commissioner, T.C. Memo. 1999-41. If the taxpayer is misguided, unsophisticated in tax law, and acts in good faith, a penalty is not warranted. See Collins v. Commissioner, 857 F.2d 1383 (9th Cir. 1988); cf. Spears v. Commissioner, T.C. Memo. 1996-341, aff'd, 98-1 USTC ¶ 50,108 (2d Cir. 1997) (court was unconvinced by the claim of highly sophisticated, able, and successful investors that they acted reasonably in failing to inquire about their investment and simply relying on offering circulars and accountant, despite warnings in offering materials and explanations by accountant about limitations of accountant's investigation).

On December 30, 2003, Treasury and the Service amended the section 6664 regulations to provide that the failure to disclose a reportable transaction, on Form 8886, "Reportable Transaction Disclosure Statement," is a strong indication that the taxpayer did not act in good faith with respect to the portion of an underpayment attributable to a reportable transaction, as defined under section 6011. Treas. Reg. § 1.6664-4(d). While this amendment applies to returns filed after December 31, 2003, with respect to transactions entered into on or after January 1, 2003, the logic of this provision applies to reportable transactions occurring prior to that effective date. Failure to comply with the disclosure provisions of the law is a strong indication of bad faith.

Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Nicole Rose Corp. v. Commissioner, supra . Reliance on professional advice, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Treas. Reg. § 1.6664-4(b)(1). The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purpose (and the relative

weight of such 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. Treas. Reg. § 1.6664-4(c)(1)(i). 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. Treas. Reg. § 1.6664-4(c)(1)(ii).

Where a tax benefit depends on nontax factors, the taxpayer also has a duty to investigate such underlying factors. See Novinger v. Commissioner, T.C. Memo. 1991-289 (taxpayer could not avoid the negligence penalty merely because his professional advisor had read the prospectus and had advised the taxpayer that the underlying investment was feasible from a tax perspective, assuming the facts presented were true). Moreover, if the tax advisor is not versed in these nontax factors, mere reliance on the tax advisor does not suffice. See Addington v. United States, 205 F.3d 54 (2d Cir. 2000) (taxpayer's reliance on tax advisor was not reasonable given the cautionary language in offering memoranda and the tax advisor's lack of adequate knowledge to evaluate essential aspects of underlying investment); Freytag v. Commissioner, 89 T.C. 849 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990) (reliance on tax advice not reasonable where taxpayer did not consult experts with respect to the bona fides of the financial aspects of the investment); Goldman v. Commissioner, 39 F.3d 402 (2d Cir. 1994) (taxpayer's reliance on accountant's advice to invest in a partnership engaged in oil and gas was not reasonable where accountant lacked industry knowledge); Collins v. Commissioner, 857 F. 2d 1383 (9th Cir. 1988) (penalties upheld where advisor "knew nothing firsthand" about the venture).

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. Treas. Reg. § 1.6664-4(c)(1). In Nicole Rose Corp. v. Commissioner, supra, the Service argued that the Nicole Rose Corp. was liable for the accuracy related penalty because it disregarded the economic substance of the transaction. The court held that the participation of highly paid professionals provides petitioner no protection, excuse, justification, or immunity from the penalties in issue. In finding the petitioner liable for the accuracy-related penalties under section 6662(a), the court concluded that the petitioner participated in a clear and obvious scheme to reap the benefits of claimed ordinary business expense deductions that had no business

purpose and no economic substance. For a taxpayer's reliance on advice to be sufficiently reasonable so as possibly to negate a section 6662(a) accuracy-related penalty, the Tax Court in Neonatology Associates P.A. v. Commissioner, 115 T.C. 46 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002), 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. For a taxpayer to rely on an advisor's judgment, the advisor must not be someone burdened with an inherent conflict of interest, such as a promoter. Pasternak v. Commissioner, 990 F.2d 893 (6th Cir. 1993). Additionally, a taxpayer must be able to show that an advisor reached a decision independently. Neuman v. Commissioner, T.C. Memo. 1998-126.

Although a professional tax advisor's lack of independence is not alone a basis for rejecting a taxpayer's claim of reasonable cause and good faith, the fact that a taxpayer knew or should have known of the advisor's lack of independence is strong evidence that the taxpayer may not have relied in good faith upon the advisor's opinion. Goldman v. Commissioner, *supra*; Pasternak v. Commissioner, *supra* at 903 (finding reliance on promoters or their agents unreasonable, as "advice of such persons can hardly be described as that of 'independent professionals'"); Roberson v. Commissioner, 98-1 U.S.T.C. 50,269 (6th Cir. 1998) (dismissing taxpayer's purported reliance on advice of tax professional due to professional's status as "promoter with a financial interest" in the investment); Rybak v. Commissioner, 91 T.C. 524, 565 (1988) (sustaining negligence penalty where taxpayers relied only upon advice of persons who were not independent of promoters); Illes v. Commissioner, 982 F.2d 163 (6th Cir. 1992) (finding reliance upon professional with personal stake in venture not reasonable); Gilmore & Wilson Construction Co. v. Commissioner, 99-1 U.S.T.C. 50,186 (10th Cir. 1999) (finding taxpayer liable for negligence since reliance on representations of the promoters and offering materials unreasonable); Neonatology Associates, P.A. v. Commissioner, 299 F.3d 221 (3d Cir. 2002) (reasoning reliance may be unreasonable when 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). Similarly, the fact that a taxpayer consulted an independent tax advisor is not, standing alone, conclusive evidence of reasonable cause and good faith if additional facts suggest that the advice is not dependable. Edwards v. Commissioner, T.C. Memo. 2002-169; Spears v. Commissioner, *supra*. For example, a taxpayer may not rely on an independent tax adviser if the taxpayer knew or should have known that the tax adviser lacked sufficient expertise, the taxpayer did not provide the advisor with all necessary information, the information the advisor was provided was not accurate, or the taxpayer knew or had reason to know that the transaction was "too good to be true." Baldwin v. Commissioner, T.C. Memo. 2002-

162; Spears v. Commissioner, supra.

With respect to reasonable cause for the substantial understatement penalty attributable to tax shelter items of a corporation, special rules apply; see section 6662(d)(2)(C)(iii) for the definition of a tax shelter. The determination of whether a corporation acted with reasonable cause and good faith is based on all pertinent facts and circumstances. Treas. Reg. §1.6664-4(f)(1). 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, at a minimum, if there is substantial authority within the meaning of Treas. Reg. §1.6662-4(d) for the treatment of the item and the corporation reasonably believed, when the return was filed, that such treatment was more likely than not the proper treatment. Treas. Reg. §1.6664-4(f)(2)(i).

The regulations provide that a corporation meets the reasonable belief requirement if the corporation analyzed pertinent facts and relevant authorities to conclude in good faith that there would be a greater than 50 percent likelihood (“more likely than not”) that the tax treatment of the item would be upheld if challenged by the IRS; or the corporation reasonably relied in good faith on the opinion of a professional tax advisor if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in Treas. Reg. §1.6662-4(d)(3)(ii) and the opinion unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Service. (See Treas. Reg. §1.6664-4(c) for requirements with respect to the opinion of a professional tax advisor upon which he foregoing discussion elaborates). Treas. Reg. §1.6664-4(f)(2)(i)(B)(1) and (2). Therefore, if possible, the tax advisor's opinion should be obtained to determine whether these requirements are met.

Satisfaction of the minimum requirements for legal justification is an important factor in determining whether a corporation acted with reasonable cause and in good faith, but not necessarily dispositive. See Treas. Reg. § 1.6664-4(f)(3). 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 protect the confidentiality of the tax aspects of the structure of the tax shelter. Treas. Reg. § 1.6664-4(f)( 3). Failure to satisfy the minimum standards will, however, preclude a finding of reasonable cause and good faith based (in whole or in part) on a corporation's legal justification. See Treas. Reg. § 1.6664-4(f)(2)(i).

Other facts and circumstances also may be taken into account regardless of whether the minimum requirements for legal justification are met. See Treas. Reg. § 1.6664-4(f)(4).

## **SETTLEMENT GUIDELINES**

Each intermediary transaction is unique and hence the issues raised may differ. The various legal doctrines discussed herein stem from a long history of judicial review. The settlement of these issues will be driven by the application of these legal principles to the specific facts and circumstances of each case. As such, it is the strength of the facts and circumstances, as considered in light of the judicial doctrines that will determine the appropriate settlement range.

Transferee Liability Issue: The intermediary corporation is merely used to facilitate the transactions. Typically, it has little or no assets left from which to collect any tax assessed and due from the disallowance of the inflated basis asset loss. Consequently, transferor/transferee liability examination work may have been conducted concurrently with the examination of the intermediary transactions. Coordinate the transferor/transferee liability as appropriate with the Appeals ISP Coordinator, Corporate Tax Shelters-Leasing Promotions and Intermediary Transactions.

### **1. Allowability of Losses and Deductions Reported By Intermediary**

#### **Sham/Lack of Economic Substance**

The courts have provided a wealth of insight into transactions that are structured to produce results that are not intended by Congress. In those instances where the evidence establishes such orchestration, the courts have found for the Commissioner. Based upon the facts and circumstances exhibited to date, there is strong support for the Service's position that intermediary transactions are abuses that Congress had not intended. When coupled with the fact that intermediary transactions, taken as a whole, have no business purpose independent of tax considerations and lack economic substance, the Service is posed with limited hazards in litigation

In evaluating the merits of a particular intermediary transaction, it is important to understand the flow of the transactions. Recent court decisions Andantech L.L.C. v. Commissioner, supra; Nicole Rose Corp. v. Commissioner, supra and Long Term Capital Holdings v. United States, supra, indicate that the courts will look beyond the form of the transactions, including steps that were entered into prior to the taxpayer's investment, to ascertain the true intent (substance) of the transactions. In this regard, the more facts that can be developed that show the relationships between the parties and the prearrangements between them, the more likely the victory for the Service.

The factual development of the case is crucial in formulating a settlement. Relevant facts will include: whether the sole purpose of the intermediary was to act as an accommodating party between the seller and the buyer; whether the intermediary reports losses and deductions from tax shelters that offset the gain from the sale of assets; and whether the tax shelters include lease stripping transactions and other transactions that purport to create assets with bases that exceed their fair market values. Under these circumstances the courts would find that the transactions have no business purpose and lack economic substance. See Nicole Rose Corp. v. Commissioner, supra; Andantech L.L.C. v. Commissioner, supra, and Long Term Capital Holdings v. United States, supra.

Assuming that the Service is able to establish facts similar to those set forth in the example provided in the CIP, the Service has a substantially stronger case than the taxpayer. Given the recent judicial climate with respect to tax shelters, it is the taxpayer who is posed with significant hazards in litigation.

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## 2. Treatment of M as a Conduit and Recharacterization of Transaction

As set forth in Notice 2001-16, 2001-9 IRB 730, and presented by compliance's CIP, case law supports recasting intermediary transaction tax shelters when the substance of M's participation in the transaction is to serve as a conduit and shelter the gain associated with the sale of T's assets for a fee. That judicial doctrine is fully discussed above. The intermediary corporation M is a conduit that is disregarded for federal income tax purposes and the transaction is treated as if either (1) the target corporation T sold its assets directly to the ultimate buyer Y of the assets and made a liquidating distribution to its shareholder(s) X, or (2) X sold its T stock directly to Y followed by Y's liquidation of T. Whether the recast of the transaction is a direct asset sale by T of its assets to Y or a direct stock sale by X of its T stock to Y will depend on the facts and circumstances of the particular case.

If the substance of the transaction is determined to be an asset sale, the transaction will be recast as follows: target corporation sells the assets directly to the buyer and distributes the proceeds from the asset sale to the seller's former shareholder(s).<sup>12</sup> The target corporation's loss that was used to offset the gain will be disallowed and the target corporation will have a tax liability. However, the target corporation may no longer be in existence following the transaction and may lack assets needed to pay a tax liability. Consequently, the selling shareholder(s) may be responsible for the target corporation's unpaid tax as a transferee.

If the substance of the transaction is determined to be a stock sale, the transaction will be recast as follows: shareholders of the target corporation are treated as selling the target corporation's stock directly to the buyer followed by the target corporation's distribution of its assets to the buyer in liquidation. Consequently, the purchaser will not be entitled to the basis step-up as reflected on the original return.<sup>13</sup>

In either case the hazards inherent in the judicial argument will necessarily flow from the case development and the particular facts of the case. The factual development of the case is crucial in formulating a settlement. Relevant facts include: whether negotiations between the asset purchaser and the target corporation and/or its shareholders began before the intermediary became involved in the transaction, whether the asset purchaser and the target corporation and/or its shareholders had reached an agreement to consummate the transaction as a stock sale or asset

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<sup>12</sup> Notice 2001-16 provides an alternative recast that the corporation distributed its asset to the seller (its original shareholder(s) who sell the assets to the buyer).

<sup>13</sup> This analysis is valid if the purchaser is a corporation. If not, contact the Appeals ISP Coordinator, Corporate Tax Shelters – Leasing Promotions, for advice.



purchase before the intermediary became involved, whether the intermediary had been introduced into the transaction on behalf of either the asset purchaser or the target corporation and/or its shareholders, whether the transaction as consummated by the intermediary was on terms agreed to by the asset purchaser and the target corporation and/or its shareholders, how the intermediary was compensated for its participation in the transaction, and whether the asset purchaser and the target corporation and/or its shareholders facilitated financing for the intermediary.

If the facts are the same as or similar to those described in Notice 2001-16 and are supported by the proper documentation, Appeals is of the opinion that the taxpayer is faced with significant hazards of litigation. Under these circumstances any settlement should strongly favor the Service.

### **3. PENALTIES:**

The Compliance CIP recommends assertion of the accuracy-related penalty under section 6662 or the fraud penalty under section 6663. Whether penalties apply to underpayments attributable to intermediary transaction tax shelters must be determined on a case-by-case basis based upon the application of the legal standard for the penalty (as set forth in the Discussion section of this guideline) to the specific facts and circumstances of each case.

The accuracy-related penalty has been sustained in the tax shelter area. In Nicole Rose Corp. v. Commissioner, supra, petitioner argued that penalties did not apply because it had reasonably relied on qualified advisors concerning an issue of first impression. The court rejected that argument finding that the scheme was so clear and obvious that the participation of professionals could not shelter petitioners from the penalties. See also Neonatology Associates P.A. v. Commissioner, supra; and Long Term Capital Holdings v. United States, supra.

#### **Negligence or Disregard of Rules or Regulations**

Appeals believes 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. If the facts establish that the intermediary reported losses from a transaction that lacked economic substance or the asset purchaser or the original shareholders brought in the intermediary for the sole purpose of absorbing the corporate level tax, then the accuracy-related penalty attributable to negligence may be applicable if there was no reasonable attempt to ascertain the correctness of the

claimed losses or deductions. Taxpayers who point solely to the opinions of the promoter of the transaction, or a law firm or similar entity associated with the promoter for purposes of the transaction, should not be viewed as having made a reasonable attempt to ascertain the correctness of the income exclusion. In these cases, no concession of the penalty is warranted.

Taxpayers participating in or filing returns claiming tax benefits from, Intermediary Transaction Tax Shelters transactions after the issuance of Notice 2001-16 on February 26, 2001 took positions contrary to a notice and would be subject to an accuracy-related penalty for disregarding a rule. See Treas. Reg. § 1.6662-3(b)(2) (defining rules or regulations to include notices other than notices of proposed rulemaking). For Intermediary Transaction Tax Shelter transactions predating the issuance of Notice 2001-16, a taxpayer could be liable for the negligence penalty based upon a 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.



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### **Substantial Understatement**

Appeals believes that the transactions at issue will meet the definition of a tax shelter, and that the taxpayers will lack substantial authority for their positions. Accordingly, the accuracy-related penalty will apply in most cases based on a substantial understatement of income tax.

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 v. Commissioner, supra, (reasoning that while good faith reliance on professional advice may establish reasonable cause, “reliance may be unreasonable

when it is placed upon insiders, executives, 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.”) In addition, if the taxpayer did not receive the opinion letter until after the return was filed, the taxpayer could not have reasonably relied on the opinion and thus should not be relieved from penalties. See Long Term Capital Holdings v. United States, supra.

In Long Term Capital Holdings, supra, the court concluded that a legal opinion did not provide a taxpayer with reasonable cause where (1) the taxpayer did not receive the written opinion prior to filing its tax return, and the record did not establish the taxpayer’s receipt of an earlier oral opinion upon which it would have been reasonable for the taxpayer to rely; (2) the opinion was based upon unreasonable assumptions; (3) the opinion did not adequately analyze the applicable law; and (4) the taxpayer’s partners did not adequately review of the opinion to determine whether it would be reasonable to rely on it. In addition, the court concluded that the taxpayer’s lack of good faith was evidenced by its decision to attempt to conceal the losses reported from the transaction by netting them against gains on its returns.

On December 30, 2003, Treasury and the Service amended the Section 6664 regulations to provide that the failure to disclose a reportable transaction, on Form 8886, “Reportable Transaction Disclosure Statement,” is a strong indication that the taxpayer did not act in good faith with respect to the portion of an underpayment attributable to a reportable transaction, as defined under Section 6011. See Treas. Reg. § 1.6664-4(d). While this amendment applies to returns filed after December 31, 2002, with respect to transactions entered into on or after January 1, 2003, the logic of this provision applies to reportable transactions occurring prior to that effective date. Failure to comply with the disclosure provisions of the law is a strong indication of bad faith. See Long Term Capital Holdings v. United States, supra.

Appeals believes that litigation hazards with respect to the applicability of the accuracy-related penalty based on a substantial understatement of income tax relate to the facts of each case and development of the issue by the Government.

In determining whether a penalty applies the following factors are relevant: the sophistication of the taxpayer, whether the taxpayer obtained an outside opinion; the contents of any outside opinion; the timing of the receipt of the opinion in relation to the filing of the tax return; whether the opinion was given by an advisor connected with the promotion or promoter in contrast to the taxpayer’s regular advisor; whether the promoter arranged for the opinion; the contents of the opinion; and any efforts to conceal the transaction, mislead the Service, or fail to cooperate in the examination of

the transaction. If any of these factors are present then they should be considered in connection with the assertion or settlement of the penalty raised.

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### **Substantial or Gross Valuation Misstatement**

Appeals believes that where an Intermediary Transaction Tax Shelter involves a loss reported from an asset with a reported basis of 200 percent or more of the correct amount, an accuracy-related penalty for a substantial or gross valuation misstatement will apply. In Long Term Capital Holdings, supra, the court upheld the 40% gross valuation misstatement penalty as well as the 20% substantial understatement penalty.

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### **Fraud**

If facts are present establishing that a taxpayer attempted to conceal or mislead, such as by deliberately mislabeling an item, incorrectly reporting the relevant facts, or reporting an item so as to reduce the likelihood that it would be identified for examination, it may support the imposition of a penalty for fraud. Spies v. United States, 317 U.S. 492, 499 (1943). Similarly, implausible or inconsistent explanations of behavior are an indicia of fraud. Grosshandler v. Commissioner, 75 T.C. 1, 20 (1980). If one or more of the foregoing facts are present, then the fraud penalty may be applicable.

Appeals will consider the appropriateness of the proposed fraud penalty based on the facts of the case.