Effective Date: December 19, 2002

**COORDINATED ISSUE**
**ALL INDUSTRIES**
**INTERMEDIARY TRANSACTION TAX SHELTERS**
**UIL 9300.16-00**

## 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 (T) 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 T stock directly to Y followed by Y's liquidation of T.

3. Whether penalties apply to underpayments attributable to intermediary transaction tax shelters.

## CONCLUSIONS

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) and Andantech L.L.C. v. Commissioner, T.C. Memo. 2002-97, 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, examination personnel are encouraged to coordinate with the Leasing Technical Advisor and to seek the advice of Counsel.

2. Whether an intermediary transaction is properly recast as a direct sale by T of its assets to Y or a direct sale by X of its T 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, T, 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.

## FACTS

The parties to the intermediary transaction are X, a seller that desires to sell stock (not the assets) of the target corporation T; M, a corporation that serves as an intermediary that will shelter any income generated in the transaction; and Y, a buyer that desires to purchase the assets (not the stock) of T. Pursuant to a plan, the parties undertake the following steps: X purports to sell the stock of T to M. T then liquidates into M, purportedly under section 332 of the Internal Revenue Code.[1] M then sells some or all of the T assets to Y in a transaction that generates gain to M.[2] 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) of the Internal Revenue Code that offset the gain from the sale of the T assets to Y.[3] The tax shelters frequently include lease stripping transactions and other transactions that purport to create assets with bases that exceed their fair market values.

## DISCUSSION

### 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

[1] 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).

[2] In some cases, the assets of T are sold to Y before M acquires T's stock.

[3] 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.

on a case-by-case basis depending on the specific facts and circumstances of each case.[4] Often, the losses or deductions will not be allowable because, as in Nicole Rose Corp. v. Commissioner, supra and Andantech L.L.C. v. Commissioner, 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 (11th 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 (11th 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 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

[4] 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.

taxpayer's beneficial interest, absent tax benefits. Knetsch v. United States, 364 U.S. 361, 366 (1960); ACM Partnership, 157 F.3d 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, 364 U.S. 361 (1960). Modest or inconsequential profits relative to substantial tax benefits are insufficient to imbue an otherwise questionable transaction with economic substance. ACM Partnership, 157 F.3d 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, 157 F.3d at 257.

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.[5] 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.[6] 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 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

[5] Quintron's name was later changed to Nicole Rose Corp.

[6] The balance of the loan was offset by Quintron accounts receivable that were not transferred to Loral.

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.

In ACM Partnership, 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. T.C. Memo. 1997-115. 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. Id. 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 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 be a tax indifferent entity with 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 v. Commissioner, 117 T.C. 328 (2001). 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, supra, 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,[7] for its

[7] In Nicole Rose, supra, the intermediary was able to use the purported losses from

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 and non-disclosure agreements to protect the secrecy of 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).

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 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 exists 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 Robert G. Kluener v. Commissioner, 154 F.3d 630 (6th Cir. 1998).[8] In Davis v. Commissioner, 88 T.C. 122 (1987), a bank's foreclosure on partnership's property and the bank's subsequent

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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.

[8] In Estate of Robert G. Kluener, 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.

sale of 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 T 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 T, by T on behalf of X (which would be treated as a distribution by T 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 T's assets and such retention is not viewed as a payment of a fee, T 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 T being treated as directly selling its assets (except for the assets sold to M) to Y.

*A. Substance of Transaction as an Asset Sale*

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 is 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 is no longer in existence following the transaction and 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.

I.R.C. 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. section 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 that 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.[9]

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. Examination 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 section 1.6662-4(e) 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 sections 1.6664-4(a) through (d) apply in determining whether a corporate taxpayer had reasonable cause sufficient to avoid the accuracy-related penalty.

*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. Section 1.6662-2(c) provides that there is no stacking of the accuracy-related penalty components. Thus, the maximum

[9] This will require a separate examination of the asset purchaser. It is therefore important to protect the statute of limitations of the asset purchaser.

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. Section 6662(b).

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 Section 6662(c) and Section 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). Section 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.

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. Section 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.

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. Section 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. Section 1.6662-3(b)(2).

A substantial understatement of income tax exists for a taxable year if the amount of 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). Section 6662(d)(1). Understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was 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. Section 6662(d)(2)(B). In the case of items of taxpayers other than corporations attributable to tax shelters, exception (2) above does not apply and exception (1) applies only if the taxpayer also reasonably believed that the tax treatment of the item was more likely than not the proper treatment. Section 6662(d)(2)(C)(i). In the case of items of corporate taxpayers attributable to tax shelters, neither exception (1) nor (2) above applies. Section 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 Section 1.6664-4(e) for special rules relating to the definition of reasonable cause in the case of a tax shelter item of a corporation. The definition of tax shelter includes, among other things, any plan or arrangement a significant purpose of which is the avoidance or evasion of federal income tax. Section 6662(d)(2)(C)(iii). 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. Section 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), a substantial understatement penalty may be applicable.

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). 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. Section 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." Section 6662(h)(2)(A). If there is a gross valuation misstatement, then the 20% penalty under section 6662(a) is increased to 40%. Section 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).

*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. Section 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 with respect 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. Section 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. Section 1.6664-4(b)(1). Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Id.

Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Nicole Rose v. Commissioner, 117 T.C. 328 (2001). 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. Id.; see also United States v. Boyle, 469 U.S. 241 (1985) (reasonable cause is established when a taxpayer shows that he reasonably relied on the advice of an accountant or attorney). In determining whether a taxpayer has reasonably relied on professional tax advice as to the tax treatment of an item, all facts and circumstances must be taken into account. Section 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. Section 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. Section 1.6664-4(c)(1)(i). Further, 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. Section 1.6664-4(c)(1). In Nicole Rose Corp. v. Commissioner, 117 T.C. 328 (2001), 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 Neonatalogy Associates P.A. v. Commissioner, 115 T.C. 46 (2000) 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.

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. Section 1.6664-4(e)(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 Section 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. Section 1.6664-4(e)(2)(i).

The regulations provide that in meeting the requirement of reasonably believing that the treatment of the tax shelter item was more likely than not the proper treatment, the corporation may reasonably rely 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 Section 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. Section 1.6664-4(e)(2)(i)(B)(2). Therefore, if possible, the tax advisor's opinion should be obtained to determine whether these requirements are met.

Although satisfaction of the "substantial authority" and "belief" requirements is necessary to a reasonable cause finding, this may not be sufficient. 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. Section 1.6664-4(e)(3).