

**APPEALS
COORDINATED ISSUE PROGRAM
APPEALS SETTLEMENT GUIDELINES**

Industry **Abusive Tax Avoidance Transactions**

Issue: **Transactions Involving the Use of a Loan Assumption
Agreement to Claim an Inflated Basis in Assets Acquired
from Another Party**

Also Known As: The CARDS Issue

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Factual / Legal Issue: **Factual and Legal**

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Appeals Settlement Guideline

Transaction Involving the Use of a Loan Assumption Agreement to Claim an Inflated Basis in Assets Acquired from Another Party

Also Known As the CARDS Issue

UIL Number: 9300.19-00

Gerald Savard
Appeals Technical Guidance Coordinator

Executive Summary

In Notice 2002-21; 2002-14 IRB 730 (March 18, 2002), the Internal Revenue Service and the Treasury Department announced that they had become aware of a type of transaction used by taxpayers to generate tax losses. The Notice alerted taxpayers and their representatives that the tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. The Notice also alerted taxpayers, their representatives, and promoters of these transactions of certain responsibilities that may arise from participating in these transactions.

This issue is commonly known as the CARDS Issue. CARDS is an acronym for Custom Aadjustable Rate Debt Structure.

The transaction purportedly creates a permanent tax deduction (either ordinary or capital loss) when a taxpayer acquires property from a limited liability company ("LLC"), assumes, as consideration, joint and several liability for debt of the LLC that exceeds the value of the property (and claims basis in the property in the full amount of the debt), and then disposes of the property at a loss. The Government argues that the CARDS transaction creates an artificial, non-economic loss that is used to offset unrelated taxable income.

On March 17, 2004, this issue was designated as an Appeals Coordinated Issue. See Internal Revenue Manual § 8.7.3.11.

Typically, the transaction involves four parties:

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|---|---|---|
| 1 | The Promoter | |
| 2 | A Limited Liability Company (LLC) or (Transferor) | The LLC is set up by the promoter to facilitate the transaction. The LLC members are nonresident alien individuals. |
| 3 | A Foreign Bank | The foreign bank is used to facilitate the loan agreements used in the transaction. |
| 4 | A U.S. Taxpayer (the taxpayer) | The U.S. taxpayer has an unrelated gain that needs sheltering from Federal income tax. |

Generally, the transaction involves the use of a loan assumption agreement to claim an inflated basis in assets acquired from another party. In one variation of a typical transaction, the transferor borrows money on a long-term basis and uses the proceeds to purchase assets, such as short-term deposits, government bonds, or high-grade corporate debt. The assets may be denominated in a foreign currency and serve as collateral for the loan. The collateral is used to satisfy the interest payments as they become due. Under a separate agreement between the LLC (the transferor) and a U.S. taxpayer, the transferor transfers a portion of the assets (the conveyed assets) to the taxpayer in exchange for the taxpayer becoming jointly and severally liable to the lender as a co-obligor. Also pursuant to the agreement between the transferor and the taxpayer, the transferor agrees to make all interest payments on the loan, and the taxpayer agrees to pay the principal due at maturity. The co-obligors and the lender anticipate that the collateral will be substantially (if not entirely) sufficient to repay the loan. The taxpayer, claiming that the entire principal amount of the loan is included in its basis in the conveyed assets because of its assumption of joint and several liability on the loan, sells the conveyed assets at their fair market value and claims a loss in an amount equal to the excess of the stated principal amount of the loan over the fair market value of the conveyed assets.

There are two primary arguments raised by the Government against the CARDS transactions:

- ? The taxpayer's basis in the assets acquired from the LLC does not equal the full loan amount. Rather, it equals their fair market value on the acquisition date.
- ? The claimed losses, including transaction costs, should be disallowed because the CARDS transaction as a whole lacks economic substance and business purpose apart from tax savings.

Additionally, the Government argues that the losses may be disallowed under I.R.C. §§ 165, 465 and 988; and, that the loan does not constitute genuine indebtedness for Federal income tax purposes.

Finally, the Government argues that, on a case by case basis, taxpayers who have invested in the CARDS transaction may be liable for the accuracy-related penalty under the provisions of I.R.C. § 6662.

Taxpayers argue that the CARDS transaction meets the requirements of the Internal Revenue Code and Regulations. In addition to disputing all other arguments raised by the Government, the taxpayers argue that the transaction does not lack economic substance or a profit potential other than tax savings.



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The Issues

- 1 May a taxpayer claim a loss in an amount equal to the excess of the stated principal amount of a loan over the fair market value of conveyed assets?
- 2 Whether an accuracy-related penalty imposed by the Internal Revenue Service under the provisions of I.R.C.¹ § 6662 against taxpayers² who invested in the CARDS transaction is appropriate.

Issue 1 Statement of the Issue

Sub-Issues

The Government has identified the following sub-issues:

- 1 Is the taxpayer's basis in the assets acquired from the LLC equal to the full loan amount, or is it limited to their fair market value on the acquisition date?
- 2 Is the taxpayer's loss a bona fide loss allowable under I.R.C. § 165?

¹ As used herein, I.R.C. refers to the Internal Revenue Code of 1986.

² As used herein, the term "taxpayer" refers to an "investor" in the transactions. These "investors" may be individuals, partnerships, corporations or trusts.

- 3 Is the taxpayer's loss limited by the I.R.C. § 465 at risk provisions?
- 4 Do the provisions of I.R.C. § 988 limit any claimed foreign currency losses?
- 5 Does the "loan" to the LLC constitute genuine indebtedness for Federal Income Tax purposes?
- 6 Whether the purported losses and transaction costs may be disallowed because the Notice 2002-21 transaction as a whole lacks economic substance and business purpose apart from tax savings.

The Government's Position

As to the sub-issues enumerated above, it is the Government's position that:

- 1 The taxpayer's basis in the assets acquired from the LLC is limited to their fair market value as of the date of acquisition.
- 2 The taxpayer's loss is not a bona fide loss allowable under I.R.C. § 165.
- 3 The taxpayer's loss is limited by the I.R.C. § 465 at risk provisions.
- 4 The taxpayer is not entitled to a loss under I.R.C. § 988.
- 5 The purported loan to the LLC does not constitute genuine indebtedness and the taxpayer's subsequent assumption of that indebtedness has no effect for Federal income tax purposes.
- 6 The taxpayer's loss is not allowable because the Notice 2002-21 transaction as a whole lacks economic substance and business purpose apart from tax savings.

The Taxpayers' Position

In general, it is the taxpayers' position that, for Federal income tax purposes:

- 1 The transaction would constitute a sale of the assets by the LLC to the taxpayer.
- 2 The taxpayer's tax basis in the assets would equal the principal amount of the loan plus the amount of cash and the fair market value of other consideration paid by the taxpayer to the LLC.

- 3 Any gain or loss recognized by the purchaser upon the disposition of nonfunctional currency would be characterized as ordinary income or loss.

Issue 1 Brief Description

The General Facts

In general, the transaction involves the use of a loan assumption agreement to claim an inflated basis in assets acquired from another party. This inflated basis is claimed as a result of a transfer of assets in which a U.S. taxpayer ("taxpayer" or "purchaser") becomes jointly and severally liable on indebtedness of the transferor of the assets ("transferor" or "LLC"), with the indebtedness having a stated principal amount substantially in excess of the fair market value of the assets transferred. The transferor may not be subject to U.S. tax or otherwise may be indifferent to the federal income tax consequences of the transaction.

In one variation of the transaction, the transferor borrows money from a lender (lender or bank) on a long-term basis such as 30 years (the "loan"). The amount borrowed may be in a foreign currency. Interest is payable at regular intervals, and principal is due at maturity. The loan may permit prepayment. The loan is made with full recourse to the transferor.

The transferor uses the proceeds to purchase assets (the "Assets"), such as short-term deposits, government bonds, or high-grade corporate debt, which may be denominated in a foreign currency. The Assets serve as collateral for the loan pursuant to a loan agreement. As each interest payment becomes due, the collateral is used to satisfy such payments. Upon maturity or earlier payment, the loan is satisfied, by its terms, first from the collateral, and only then against transferor (or the transferor and any party that has assumed the liability as a joint and several obligor) to satisfy any shortfall.

Pursuant to a separate agreement between the transferor and the taxpayer, the transferor transfers a portion of the Assets to the taxpayer in consideration for the taxpayer's agreement to become jointly and severally liable to the lender as a co-obligor on the loan. The fair market value of the Assets transferred to the taxpayer equals the present value of the loan's principal payment at maturity, determined by using a market rate of interest. Thus, the fair market value of the Assets is substantially less than the loan's stated principal amount. The taxpayer provides substitute collateral for the loan, with the value of the collateral equal to that of the Assets. The remainder of the Assets owned by the transferor continue to serve as collateral for the loan.

Also pursuant to the agreement between the transferor and the taxpayer, the transferor agrees to make all interest payments on the loan, and the taxpayer agrees to pay the principal due at maturity. The co-obligors and the lender anticipate that the collateral will be substantially (if not entirely) sufficient to repay the loan.

The taxpayer subsequently disposes of the Assets for their fair market value. The taxpayer claims that, as a result of its assumption of joint and several liability on the loan, the entire principal amount of the loan is included in the taxpayer's basis in the Assets. As a result, the taxpayer claims a loss for federal income tax purposes in an amount equal to the excess of the stated principal amount of the loan over the fair market value of the Assets. If the Assets are nonfunctional currency, the taxpayer claims an ordinary loss.

Steps Involved in the Transaction

The specific steps in the transaction can be described as follows:

1 **The Formation of an LLC**

The promoter creates a special purpose limited liability company (“LLC”). The LLC members are two nonresident alien individuals. The initial capital contribution to the LLC consists of recourse notes from the members.

2 **Origination of the Loan / Credit Agreement**

The LLC enters into a thirty-year balloon loan agreement with a bank. The balloon loan, which is also called a bullet loan, is a long-term loan that has one large principal payment due at maturity coupled with periodic interest payments. The loan is usually denominated in Euros or another foreign currency. The borrowing may also be structured using U.S. Dollars. Under the terms of the credit agreement, interest on the loan is payable annually and accrues at a rate based on a formula tied to the London Inter-Bank Offer Rate (“LIBOR”), which is the interest rate that the largest international banks charge each other for loans. The interest rate is usually re-set on an annual basis. The loan may be repaid without premium or penalty on or after the first interest re-set date. The LLC has the right to assign its obligations under the credit agreement to another party as co-obligor subject to the approval of the lending bank.

3 **Establishment of the Collateral Account**

The LLC is required to deposit the loan proceeds or assets acquired with those funds plus an additional amount of cash into a collateral account

deposited with the lender subject to a lien in favor of the lending bank that also acts as the account custodian. The interest earned on collateral provides the source of funds to pay the annual interest accrual on the balloon loan. The security agreement specifies that the collateral must be invested in certificates of deposit, short-term deposits, highly rated commercial paper or government securities. The collateral is segregated into two separate time deposit accounts. Eighty-five percent of the collateral account funds are invested in one time deposit account with the remaining fifteen percent deposited in a separate account. The second account (15% of collateral account) appears to represent the present value of the principal loan due in thirty years calculated using the prevailing market rate of interest as of the loan origination date.

4 Sale to the Taxpayer as Co-Obligor

As noted above, under a separate agreement between the LLC (the transferor) and a U.S. taxpayer, the transferor transfers a portion of the assets (the conveyed assets) to the taxpayer in exchange for the taxpayer becoming jointly and severally liable to the lender as a co-obligor.

5 Disposition of the Conveyed Assets

Finally, the taxpayer disposes of the conveyed assets for their fair market value. The taxpayer takes the position that its basis in the conveyed assets (as a result of its loan assumption) is the entire loan amount. Therefore, the taxpayer reports a loss for Federal income tax purposes in an amount equal to the excess of the stated principal amount of the loan over the fair market value of the conveyed assets. If the original loan is denominated in U.S. currency, the taxpayer claims a capital loss. If the original loan is denominated in a foreign currency (usually Euros), the taxpayer claims an ordinary loss.

As noted, the underlying loan to LLC typically provides for a periodic resetting of the interest rate. If the parties fail to agree to continue the loan at the new rate, the loan will be repaid. In the typical Notice 2002-21 transaction, the loan is repaid with property held in the collateral accounts of the LLC and the taxpayer, shortly after the loss recognition event, at the next reset date.

**Issue 1
Discussion and Analysis**

A Discussion and Analysis of the Sub-Issues

1	Is the taxpayer's basis in the assets acquired from the LLC equal to the full loan amount or is it limited to their fair market value on the acquisition date?
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The Government's Position

The taxpayer's basis in the assets acquired from the LLC is limited to their fair market value.

I.R.C. § 1012 provides that the basis of property is equal to the cost of the property. Treas. Reg. § 1.1012-1(a) defines "cost" to mean the "amount paid" for the property in cash or other property. Under general tax law principles, the amount paid for property generally includes the amount of the seller's liabilities assumed by the buyer. Commissioner v. Oxford Paper Co., 194 F.2d 190 (2d Cir. 1952). The inclusion of liabilities in basis by a buyer, however, is predicated on the assumption that the liabilities will be paid in full by the buyer. Commissioner v. Tufts, 461 U.S. 300, 308 (1983). That rationale is absent in Notice 2002-21 transactions.

In appropriate cases, courts have rejected attempts to assign an inflated basis to property and have limited the basis of property to its fair market value. For example, the basis of property acquired with the issuance or assumption of recourse indebtedness has been limited to the acquired property's fair market value where "a transaction is not conducted at arm's-length by two economically self-interested parties or where a transaction is based upon 'peculiar circumstances' which influence the purchaser to agree to a price in excess of the property's fair market value." Lemmen v. Commissioner, 77 T.C. 1326, 1348 (1981); Bixby v. Commissioner, 58 T.C. 757, 776 (1972); Webber v. Commissioner, T.C. Memo. 1983-633, aff'd, 790 F.2d 1463 (9th Cir. 1986). See also Majestic Securities Corp. v. Commissioner, 42 B.T.A. 698, 701 (1940), aff'd, 120 F.2d 12 (8th Cir. 1941) ["The general rule that the price paid is the basis for determining gain or loss on future disposition presupposes a normal business transaction."]

Other cases have limited the portion of an assumed indebtedness that may be taken into account for Federal income tax purposes. For example, where two or more persons are liable on the same indebtedness, or hold separate properties subject to the same indebtedness, the amount taken into account for Federal income tax purposes by each person generally is based on all the facts and circumstances, including the economic realities of the situation and the parties' expectations as to how the liabilities will be paid. See Maher v. United States, No. 16253-1 (W.D. Mo. 1969) [Property was not in substance "subject to" liability where lender was not actually relying on property as collateral]; Maheer v. Commissioner, 469 F.2d 225 (8th Cir. 1972) [Corporation's assumption of primary liability on shareholder's indebtedness becomes taxable dividend only as corporation makes payments as promised]; Snowa v. Commissioner, T.C. Memo.

1995-336, rev'd on other grounds, 123 F.3d 190 (4th Cir. 1997) [Co-obligor's cost of a new residence included only her ratable share of the liability due to state law's right of contribution].

In the absence of direct authority, a supportable method of allocating basis looks to the amount of the total debt that each co-obligor can be expected to pay. In the "Notice 2002-21" transaction, as a matter of economic reality, the parties by agreement have bifurcated the loan into two parts: (1) interest with the LLC as the primary obligor and thus expected to pay; and (2) principal with the taxpayer as the primary obligor and thus expected to pay. However, in substance each will bear responsibility for repayment of the loan in accordance with their relative ownership of the collateral. Accordingly, the taxpayer's basis in the assets is equal to the fair market value of such assets upon their acquisition by taxpayer, i.e., the taxpayer's basis should be limited to the fair market value of the assets received rather than the full loan amount.

The Taxpayers' Position

I.R.C. § 1011(a) provides that for purposes of determining a taxpayer's gain or loss from the sale of an asset, the taxpayer's basis in the asset is determined under I.R.C. § 1012. I.R.C. § 1012 and Treas. Reg. § 1.1012-1(a) provide that this is the cost of the assets to the purchaser. The term "cost", however, is not defined in I.R.C. § 1012.

The courts and the IRS have consistently adopted the view that where all or a portion of the purchase price of an item of property consists of the purchaser assuming indebtedness of the seller, the purchaser's "cost", and thus its tax basis, includes the amount of the seller's liabilities assumed. This view was first articulated in Consolidated Coke Co. v. Comm'r, 70 F.2d 446 (3rd Cir. 1933), affg 25 B.T.A. 345 (1932). In that case, the taxpayer acquired the assets of another solely in exchange for assuming the liabilities of the seller. Affirming the Board of Tax Appeals, the Court concluded that the taxpayer's cost of the acquired assets equaled the amount of the liabilities assumed. This result was followed in Comm'r v. Oxford Paper Co. 194 F.2d 190 (2d Cir.1952). In Oxford, the taxpayer acquired certain assets from the seller for which it assumed liabilities of the seller under a lease. Relying on the Consolidated Coke decision, the Court held as a matter of law that the taxpayer's cost of acquiring the property included the amount of the liabilities assumed, but remanded the case for a finding as to the amount of such liabilities. In Rev. Rul. 55-675, the IRS affirmatively cited the Oxford decision and concluded that that the cost of purchased property includes the amount of liabilities assumed by the purchaser. The IRS, however, distinguished Oxford from the facts in the Ruling because of the contingent nature of the liabilities involved in the Ruling's fact pattern. See also, U.S. v. Hendler, 303 US. 564 (1938); Roberts v. Comm'r, a District Court case unofficially reported at 60-1 U.S.T.C.19120 (D.C. Ore. 1959); Smith v. Comm'r, T.C. Memo. 1965-169.

This position is consistent with the rules regarding the measurement of the amount realized by a seller in a transaction in which the buyer assumes the entire amount of the seller's liability. See, Treas. Reg. § 1.1001-2(a)(4)(ii).

However, the taxpayers recognize that, notwithstanding the foregoing, a number of cases have been cited for the proposition that a taxpayer's tax basis in purchased property cannot exceed its fair market value, even if the purchase price is wholly or partially paid with a recourse note, See, Lemmen v. Comm'r, 77 T.C. 1326 (1981), acq. 1983-2 C.B. 1; Bixby v. Comm'r, 58 T.C. 757 (1962), acq. 1975-2 C.B. 1 and acq. 1975-2 C.B. 2; Webber v. Comm'r, T.C. Memo. 1983-633, aff'd sub nom; Bryant v. Comm'r, 790 F.2d 1463 (9th Cir. 1986); and Roe v. Comm'r, T.C. Memo. 1986-510. The taxpayers, citing differences between the facts in their case and the facts before the courts, distinguish their case from the above cited cases.

2	Is the taxpayer's loss a bona fide loss allowable under I.R.C. § 165?
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The Government's Position

The taxpayer's loss is not a bona fide loss allowable under I.R.C. § 165.

I.R.C. § 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. I.R.C. § 165(b) states that, for purposes of determining the amount of such a loss, the taxpayer's basis shall be the adjusted basis as defined in I.R.C. § 1011, which provides that the basis of property is its cost.

Treas. Reg. § 1.165-1(b) provides that, to be allowable as a deduction under I.R.C. § 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in I.R.C. 165(h) and Treas. Reg. § 1.165-11 (relating to disaster losses), actually sustained during the taxable year. Treas. Reg. § 1.165-1(b) further states that only a bona fide loss is allowable and that substance and not mere form shall govern in determining a deductible loss. See also ACM Partnership v. Commissioner, 157 F.3d 231, 252 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999) ["Tax losses such as these . . . which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations."] I.R.C. § 165(c) provides that, in the case of an individual, the deduction under § 165(a) is limited to losses incurred in a trade or business, losses incurred in a transaction entered into for profit, and certain casualty or theft losses.

Here, the transactions are no more than a series of contrived steps designed to create an inflated basis in the conveyed assets purportedly equal to the principal amount of the loan plus any consideration paid to the LLC. The inflated basis, in

turn, generates an artificial loss upon the taxpayer's disposition of the conveyed assets. The taxpayer has suffered no real economic loss because that disposition constitutes an economically inconsequential investment, with the taxpayer effectively returning to the same economic position as before. See ACM Partnership v. Commissioner, 157 F.3d at 251-252. Accordingly, the loss is not allowable under § 165.

Furthermore, § 165(c) disallows the loss for an individual taxpayer. The "loss" in this transaction is not incurred in a trade or business or from a casualty or theft, within the meaning of §§ 165(c)(1) and (3). Therefore, a loss in this transaction is only allowable for an individual if it is incurred in a transaction undertaken for profit. I.R.C. § 165(c)(2); Fox v. Commissioner, 82 T.C. 1001 (1984); Smith v. Commissioner, 78 T.C. 350 (1982). For the loss to be allowable, a profit motive must be the taxpayer's primary motive for engaging in the transaction. Fox, 82 T.C. at 1020-21 (citing Helvering v. Nat'l Grocery Co., 304 U.S. 282, 289 n.5 (1938)).

A taxpayer's potential profit from this transaction, apart from tax savings, is minimal at best. The taxpayer could profit from this transaction only if the value of the assets in the taxpayer's 15% collateral account exceeded the amount of the obligation they secure, either upon maturity of the loan, or at an earlier time if the disposition occurs prior to maturity. However, the value of the collateral assets is equal to the present value of the amount necessary to pay the loan principal at maturity. The collateral funds are required to be invested in safe investments such as certificates of deposit, short term deposits, highly rated commercial paper, or government securities. Because of the rate of return expected in connection with these safe investments, there is little possibility that the collateral would exceed the loan amount. Reducing even further the possibility of profit is the short-term nature of the transaction – the underlying loan is typically repaid at the first interest reset date – and the large upfront transaction costs paid by the taxpayer. Consequently, it is unlikely that a taxpayer can demonstrate a reasonable expectation to earn more than minimal profit from this transaction, apart from tax savings. See Knetsch v. United States, 348 F.2d 932, 938 (Ct. Cl. 1965) ("[T]he statutory word 'profit' [under § 165(c)(2)] cannot embrace profit seeking activity in which the only economic gain derived therefrom results from a tax reduction.") Therefore, the loss is disallowed by § 165(c)(2).

The Taxpayers' Position

Although arguing that the transactions described herein have the requisite economic substance, the taxpayers acknowledge that, where applicable, I.R.C. § 165(c) imposes additional limitations on the ability of individuals to claim losses. If an individual incurs a loss from the disposition of the assets in the individual's trade or business, I.R.C. § 165(c)(1) generally permits the allowance of such loss. In determining whether such a business exists, the courts have required

that the criteria of I.R.C. § 183 be met. See, Farmer v. Comm'r, T.C. Memo. 1994-342.

I.R.C. § 183(a) and Treas. Reg. § 1.183-1 require that the activities with respect to which the loss relates be activities engaged in for profit. Citing the fact that there has been substantial litigation regarding whether such motive exists, the taxpayers argue that these cases have established that a taxpayer need only have a good faith expectation of earning a profit from the activities undertaken. See, e.g., Burger v. Comm'r, 809 F.2d 355 (7th Cir. 1987); Johnson v. U.S., 11 Cl. Ct. 17 (1986). Further, the taxpayers argue, even if an individual incurs a loss from the disposition of assets in a transaction which does not involve the individual's trade or business, I.R.C. § 165(c)(2) and Treas. Reg. § 1.165-1(e) allow the loss because the transaction was entered into for profit.

The taxpayers acknowledge that courts have imposed a judicial interpretation that appears to create a standard higher than that imposed by the statutes, i.e., that the taxpayer's profit motive be the "primary" motive for entering into the transaction and that when a court has thoughtfully attempted to deal with the primary standard, the results have often yielded confusion. However, the taxpayers argue that because of the factual nature of the inquiry, on balance, it is more likely than not that the requisite profit motive exists to support the deduction of any loss on the disposition of the Assets under I.R.C. § 165(c)(2).

3	Is the taxpayer's loss limited by the I.R.C. § 465 at risk provisions?
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The Government's Position

The taxpayer's loss may be limited by the I.R.C. § 465 at-risk provisions.

I.R.C. § 465 generally limits deductions for losses in certain activities to the amount for which the taxpayer is at-risk. In the case of an individual taxpayer or a C corporation with respect to which the stock ownership requirement of paragraph (2) of § 542(a) is met (after applying the attribution rule in § 544(a)), § 465 limits the taxpayer's losses to the amount for which the taxpayer is at risk in the activity. I.R.C. § 465(a)(1). I.R.C. § 465 applies to all activities engaged in by the taxpayer in carrying on a trade or business or for the production of income. I.R.C. § 465(c)(3)(A).

Under I.R.C. § 465, losses incurred in an activity engaged in by a taxpayer carrying on a trade or business or for the production of income are defined broadly to include "excess of the allowable deductions allocable to the activity over the income received or accrued by the taxpayer during the taxable year from the activity." Lansburgh v. Comm'r, 92 T.C. 448, 454-55 (1989).

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This interpretation is supported by the legislative history of § 465, which provides

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that the at-risk limitation applies to losses “regardless of the kind of deductible expenses which contributed to the loss.” S. Rept. 94-938, at 48 (1976), 1976-3 C.B. (Vol.3) 86. In this case, I.R.C. § 465 applies to the loss stemming from taxpayer's purchase of assets.

The amount at-risk includes the amount of money and the adjusted basis of any property contributed by the taxpayer to the activity, and any amounts borrowed with respect to the activity. I.R.C. § 465(b)(1). A taxpayer is also at risk for amounts borrowed for use in the activity to the extent that the taxpayer is personally liable to repay the amount, and to the extent of the fair market value of the taxpayer's interest in property, not used in the activity, pledged as security for the borrowed amount. § 465(b)(2). Amounts protected against loss by non-recourse financing, guarantees, stop loss agreements, or other similar arrangements, however, are not at-risk. I.R.C. § 465(b)(4). The Senate report promulgated in connection with § 465 states in pertinent part that "a taxpayer's capital is not 'at risk' in the business, even as to the equity capital which he has contributed to the extent he is protected against economic loss of all or part of such capital by reason of an agreement or arrangement for compensation or reimbursement to him of any loss which he may suffer." S. Rept. No. 94-938, pt. I at 49, 94th Cong., 2d Sess. (1976).

The at-risk rules in I.R.C. § 465 are most commonly applied to cases involving non-recourse liabilities; however, neither the statutory language nor the legislative history interprets the at-risk rules that narrowly. The legislative history notes that the overall purpose of the at-risk rules is to "prevent a situation where the taxpayer may deduct a loss in excess of his economic investment in certain types of activities." S. Rept. No. 938, pt. I at 48, 94th Cong., 2d Sess. (1976). The legislative history also provides that, in evaluating the amount at-risk, it should be assumed that a loss-protection guarantee, repurchase agreement or other loss limiting mechanism will be fully paid to the taxpayer. S. Rep. No. 938, 94th Cong., 2d Sess. 50 n.6 (1976), C.B. 1976-3 at 88. Although the foregoing assumption regarding loss-limiting arrangements does not explicitly claim to interpret § 465(b)(4), more than one circuit has found such an interpretation to be reasonable. See e.g., Moser v. Commissioner, 914 F.2d 1040, 1048 (8th Cir. 1990); American Principals Leasing Corp. v. Comm'r, 904 F.2d 477, 482 (9th Cir. 1990)(assuming in both cases that the reference to loss-limiting arrangements in the § 465 legislative history refers to § 465(b)(4)). I.R.C. § 465(b)(4) limits losses to amounts at risk where a transaction is structured -- by whatever method -- to remove any realistic possibility that the taxpayer will suffer an economic loss. A theoretical possibility of economic loss is insufficient to avoid the suspension of losses. See Levien v. Commissioner, 103 T.C. 120, 125 (1994).

The case law, however, is not in complete accord on this issue. In Emershaw v. Commissioner, 949 F.2d 841, 845 (6th Cir. 1991), the court adopted a worst-case scenario approach and determined that the issue of whether a taxpayer is “at risk” for purposes of I.R.C. § 465(b)(4) “must be resolved on the

basis of who realistically will be the payer of last resort if the transaction goes sour and the secured property associated with the transaction is not adequate to pay off the debt,” quoting Levy v. Commissioner, 91 T.C. 838, 869 (1988). In contrast, the Second, Eighth, Ninth, and Eleventh Circuits look to the underlying economic substance of the arrangements under I.R.C. § 465(b)(4). Waters v. Commissioner, 978 F.2d 1310, 1316 (2d Cir. 1992) (citing American Principals Leasing Corp v. United States, 904 F.2d 477, 483 (9th Cir. 1990); Young v. Commissioner, 926 F.2d 1083, 1089 (11th Cir. 1991); Moser v. Commissioner, 914 F.2d at 1048-49.) The view, as adopted by the Second, Eighth, Ninth, and Eleventh Circuits is that, in determining who has the ultimate liability for an obligation, the economic substance and the commercial realities of the transaction control. See Waters v. Commissioner, 978 F.2d at 1316; Levien v. Commissioner, 103 T.C. 120; Thornock v. Commissioner, 94 T.C. 439, 448 (1990); Bussing v. Commissioner, 89 T.C. 1050, 1057 (1987). To determine whether a taxpayer is protected from ultimate liability, a transaction should be examined to see if it “is structured - by whatever method - to remove any realistic possibility that the taxpayer will suffer an economic loss if the transaction turns out to be unprofitable.” American Principals Leasing Corp. v. United States, 904 F.2d at 483; see Young v. Commissioner, 926 F.2d at 1088; Thornock v. Commissioner, 94 T.C. at 448-49; Owens v. United States, 818 F.Supp. 1089, 1097 (E.D. Tenn. 1993); Bussing v. Commissioner, 89 T.C. at 1057-58. “[A] binding contract is not necessary for [I.R.C. § 465(b)(4)] to apply.” American Principals Leasing Corp. v United States, 904 F.2d at 482-83. In addition, “the substance and commercial realities of the financing arrangements presented . . . by each transaction” should be taken into account under I.R.C. § 465(b)(4). Thornock v. Commissioner, 94 T.C. at 449. To avoid the application of I.R.C. § 465(b)(4), there must be more than “a theoretical possibility that the taxpayer will suffer economic loss.” American Principals Leasing Corp. v United States, 904 F.2d at 483.

In the typical “Notice 2002-21” transaction, both the LLC and the taxpayer are required to leave the “borrowed funds” in accounts with the bank unless the taxpayer obtains permission to invest them in limited types of investments, which must also be left with the bank. The loan is fully collateralized by money or other property on deposit with the bank. Accordingly, I.R.C. § 465(b)(4) limits the taxpayers at-risk amount to the consideration paid to the LLC without regard to the co-obligor agreement.

It should be noted in applying the at-risk rules to a qualified C corporation that meets the ownership requirements of § 542(a), discussed above, that § 465(c)(7) provides an exception to the application of the at-risk rules for a corporation that (1) is a qualified C corporation and (2) conducts a qualifying business. A qualified C corporation is one that is not a personal holding company under § 542(a), a foreign personal holding company under § 552(a), or a personal service corporation under § 269A(b) but determined by substituting “5 percent” for “10 percent” in § 269A(b)(2). A qualifying business is an active

business that, during the entire 12-month period ending on the last day of the taxable year, had (1) at least 1 full-time employee substantially all the services of whom were in the active management of the business, (2) 3 full-time non-owner employees substantially all of the services of whom were services directly related to the business, (3) the amount of deductions attributable to such business which are allowable to the taxpayer solely by reason of §§ 162 and 404 for the taxable year exceeds 15 percent of the gross income from such business for such year, and (4) such business is not an excluded business. If the corporation is a member of an affiliated group, then, under § 465(c)(7)(F), the affiliated group is treated as a single taxpayer.

Finally, it is also notable that under § 1.1502-45(a)(2) of the regulations a subsidiary's loss is includable in the computation of consolidated taxable income and consolidated capital gain net income of its parent only in the amount that its parent is at risk in the activity at the close of the taxable year. Under § 1.1502-45(a)(3) a parent's amount at risk in an activity is the lesser of (i) the amount that the parent is at risk in the subsidiary or (ii) the amount the subsidiary is at risk in the activity.

The Taxpayers' Position

I.R.C. § 465(a)(1) provides that a loss incurred by an individual engaged in certain activities described in that section is only allowable to the extent the individual is "at risk" for such activity at the close of the taxable year. I.R.C. § 465(b)(2) provides that a taxpayer is considered "at risk" to the extent that the taxpayer is personally liable for repayments of such amount. This has been articulated by the courts as being the person who is "the obligor of last resort". See, Melvin v. Comm'r, 88 T.C. 63 (1987) aff'd, 894 F.2d 1072 (9th Cir. 1990). As discussed above, the taxpayer (purchaser) is fully liable as a co-obligor on the Loan and, consequently, the purchaser should be treated as having personal liability with respect to the Loan for purposes of I.R.C. § 465(a).

Notwithstanding this general rule, I.R.C. § 465(b)(4) reduces the amount a taxpayer is at risk to the extent the taxpayer is protected against loss through guarantees, stop loss agreements or similar arrangements. In the instant case there are no per se stop loss arrangements. In Treas. Reg. § 1.465-1(b) and Treas. Reg. § 1.465-24(a)(2), the Treasury has taken the position that where two 50/50 partners borrowed money from a bank to purchase equipment in which the bank retained a security interest, and each had a right of contribution against the other under local law, each partner is at risk for only 50% of the debt, because the local law right of contribution had to be taken into account. The Tax Court has also adopted this view in Melvin v. Comm'r, supra, and Abramson v. Comm'r, 86 T.C. 360 (1986). In the instant case, however, the purchaser and LLC have waived their respective rights of contribution against each other, with the result that no such rights remain that would constitute an effective stop loss arrangement under the foregoing authority.

In sale-leaseback cases where the purchaser-lessor has had certain set-off rights against the seller-lessee, however, the courts are divided as to whether such set-off rights constitute an I.R.C. § 465(b)(4) arrangement. In American Principals Leasing Co. v. U.S., 904 F.2d 477 (9th Cir. 1990), the Ninth Circuit Court of Appeals applied the standard of whether there was a "realistic possibility" that the taxpayer would incur an economic loss from the arrangements. The "realistic possibility" standard was also applied by Eight Circuit in Moser v. Comm'r, 914 F.2d 1040 (8th Cir. 1990), the Eleventh Circuit in Young v. Comm'r, 926 F.2d 1083 (11th Cir. 1990), the Second Circuit in Waters v. Comm'r, 978 F.2d 1310 (2nd Cir. 1992), and the Tax Court in Levien v. Comm'r, 103 T.C. 12 (1994), affd 77 F.2d 497 (11th Cir. 1996); cert. denied 116 S. Ct. 2501. On the other hand, the Sixth Circuit Court of Appeals has applied a less stringent standard to similar facts requiring only that the taxpayer be required to make good the loss if the other parties to the arrangement were insolvent or otherwise unable to pay, i.e., a "worst case scenario" basis. Emershaw v. Comm'r, 949 F.2d 841 (6th Cir. 1991). In the instant case, however, there are no set off rights equivalent to those found in these sale-leaseback cases.

Lastly, it can be argued that traditional commercial arrangements which have the economic effects of mitigating a taxpayer's risk of loss are not covered by I.R.C. § 465(b)(4).³ In Laureys v. Comm'r, 92 T.C. 101 (1989), acq. in part and nonacq. in part, 1990-2 C.B. 1, the Tax Court held that when a taxpayer hedged against risk through offsetting straddle positions, such offsetting positions were not covered by I.R.C. § 465(b)(4). Rather, the Court concluded that I.R.C. § 465(b)(4) was intended to address "new and creative" methods of protecting a taxpayer against loss.

No authority addresses I.R.C. § 465(b)(4) in a situation in which a taxpayer is a co-obligor with another person. Arguably such arrangement is not "new and creative". Furthermore, under the "worst case" scenario approach of the Emershaw case, the existence of LLC as a co-obligor would be disregarded in assuming whether the purchaser would be required to pay off the Loan in full. On the other hand, a court applying the "realistic possibility" standard of the American Principals Leasing case might come to another conclusion, although the instant case is factually distinguishable from that case because of the absence of set off rights. In addition, because the parties have waived their respective rights of contribution against one another, the instant case is distinguishable from the partnership example on the Treasury Regulation and the Melvin and Abramson cases.⁴

³ The taxpayer likely will argue that neither the co-obligor agreement, nor the collateral arrangement in which the Bank retains control of the loan proceeds, is the type of new and creative arrangement to which the court referred in Laureys.

⁴ Based on the foregoing, the taxpayer likely will argue that, on balance, the purchaser should be treated as at-risk under I.R.C. § 465(a) with respect to the entire principal amount of the Loan.

4	The taxpayer is not entitled to a loss under I.R.C. § 988.
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The Government's Position

The taxpayer is not entitled to a loss under I.R.C. § 988.

I.R.C. §§ 985-989, which were enacted as part of the Tax Reform Act of 1986, set forth a comprehensive set of rules for the treatment of foreign currency transactions. I.R.C. § 988(a)(1)(A) provides that foreign currency gain or loss attributable to an I.R.C. § 988 transaction is computed separately and treated as ordinary income or loss. Foreign currency gain on an I.R.C. § 988 transaction is generally defined as the gain on the transaction to the extent such gain does not exceed gain realized by reasons of changes in exchange rates on or after the booking date and before the payment date. I.R.C. § 988(b)(1). Foreign currency loss is similarly defined in I.R.C. § 988(b)(2). In this manner, Congress intended that only gain or loss to the extent it is realized by reason of a change in exchange rates between the date the asset or liability is taken into account for tax purposes and the date it is paid, or otherwise disposed of, will be treated as foreign currency gain or loss. S. Rep. No. 313, 99th Cong., 2d Sess. 461 (1986).

In addition, any gain or loss from the disposition of nonfunctional currency is treated as foreign currency gain or loss under the assumption that any gain or loss realized on the disposition of nonfunctional currency must be attributable to the fluctuation in the foreign exchange rates between the purchase and sale of the currency. I.R.C. § 988(c)(1)(C)(i). This is confirmed by Committee Reports describing the principles of § 988 prior to its amendment to address issues not implicated in these cases by the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). Thus, the House Ways and Means Committee Report to the Miscellaneous Revenue Act of 1988 stated "[i]n the case of any disposition of nonfunctional currency, the relevant period for measuring rate changes is the time between acquisition and disposition of the currency." H.R. Rep. No. 795, 100th Cong., 2d Sess. 296 (1988).

The legislative history of I.R.C. §§ 985-989 suggests a consistent concern about tax-motivated transactions. The Senate Finance Committee Report accompanying the Tax Reform Act of 1986 stated that one of the two reasons I.R.C. §§ 985-989 were enacted was that prior law provided opportunities for tax motivated transactions. S. Rep. No. 313., 99th Cong., 2d Sess. 450 (1986). Accordingly, in enacting I.R.C. §§ 985-989, Congress granted broad authority for the Service to promulgate regulations "as may be necessary or appropriate to carry out the purposes of [§§ 985-989] . . ." I.R.C. § 989(c). The legislative history to the TAMRA, in discussing the law prior to the enactment of TAMRA, stated, "[t]he Secretary has general authority to provide the regulations necessary or appropriate to carry out the purposes of new subpart J. For example, the

Secretary may prescribe regulations appropriately recharacterizing transactions to harmonize the general realization and recognition provisions of the Code with the policies of § 988." H.R. Rep. No. 795, 100th Cong., 2d Sess. 296 (1988); S. Rep. No. 445, 100th Cong., 2d Sess. 311 (1988) (containing identical language).

In response to Congress's concern about tax-motivated transactions, the Service, under the authority of I.R.C. § 989(c) promulgated Treas. Reg. § 1.988-2(f) and Treas. Reg. § 1.988-1(a)(11). Treas. Reg. § 1.988-2(f) states that if the substance of a transaction differs from its form, the Commissioner may recharacterize the timing, source, and character of gains or losses with respect to the transaction in accordance with the substance of the transaction. Treas. Reg. § 1.988-1(a)(11) states in part that the Commissioner may exclude a transaction or series of transactions which in form is an I.R.C. § 988 transaction from the provisions of I.R.C. § 988 if the substance of the transaction, or series of transactions, indicates that it is not properly considered an I.R.C. § 988 transaction.

In this case, the transaction at issue may be recharacterized in accordance with its substance, with the taxpayer's artificial loss being disallowed under Treas. Reg. § 1.988-2(f). For purposes of I.R.C. § 988, the substance of the transaction may be viewed as a loan from the Foreign Bank to the LLC followed by the taxpayer borrowing part of the original loan proceeds indirectly through a zero coupon loan. The computation of taxpayer's foreign currency loss does not reflect the substance of the transaction because the claimed loss is not the result of exchange rate fluctuations but rather from the overstated cost basis in the loan proceeds. Accordingly, consistent with Treas. Reg. § 1.988-2(f), the taxpayer is not entitled to deduct its artificial I.R.C. § 988 loss.

Alternatively, the loss may be excluded from I.R.C. § 988 under Treas. Reg. § 1.988-1(a)(11) because the purported loss is totally unrelated to the fluctuation of foreign currency rates. Excluding the transaction from I.R.C. § 988 will result in a capital loss. Barnes Group v. United States, 697 F. Supp 591 (D. Conn. 1988).

The Taxpayer's Position

I.R.C. § 988 governs the U.S. Federal income tax treatment of certain transactions in foreign currency, described as "section 988 transactions," and governs such transactions notwithstanding any other provisions of the Code. I.R.C. § 988(a). I.R.C. § 988 transactions are described in I.R.C. § 988(c)(1), and include the disposition of nonfunctional currency and acquiring a debt instrument pursuant to which the amount that the taxpayer is entitled to receive is denominated in a nonfunctional currency. I.R.C. § 988(c)(1)(C); Treas. Reg. § 1.988-1(a)(1)(ii)(2). The acquisition of nonfunctional currency is also treated as a section 988 transaction for purposes of determining the taxpayer's basis in such currency and determining exchange gain or loss thereon. Treas. Reg. § 1.988-1(a)(1).

In the case of transactions by individuals, I.R.C. § 988(e) limits the applicability of the I.R.C. § 988 rules to transactions other than those the expenses of which meet the requirements of I.R.C. §§ 162, 212. See I.R.C. § 988(e)(3) and Treas. Reg. § 1.988-1(a)(9).

Treas. Reg. §1.988-2(a)(1)(i) provides that the recognition of exchange gain or loss upon the sale or other disposition of nonfunctional currency is governed by the recognition provisions of the Code that apply to the sale or disposition of property, such as I.R.C. § 1001. Treas. Reg. § 1.988-2(a)(2)(i) provides that exchange gain or loss realized from the disposition of a nonfunctional currency is determined by reference to the taxpayer's basis in such currency and the amount realized. Treas. Reg. §1.988-2(a)(2)(ii)(B) provides that the exchange of nonfunctional currency for property is treated as an exchange of such currency for units of functional currency at the then spot rate and the purchase of the property for such units of functional currency. Treas. Reg. § 1.988-2(a)(2)(ii)(C) provides an example which involves the use of a nonfunctional currency to purchase items of equipment. The example concludes that such purchase is a disposition of such currency with the amount realized measured by reference to the spot price of the currency on the date of purchase and the use of such functional currency to purchase the equipment.

The taxpayers argue, it is more likely than not that the use of the Transferred Assets to purchase Euro-denominated commercial paper or other securities, which would constitute property, would be treated as a disposition of the foreign currency acquired from LLC⁵ on which gain or loss is recognized under Treas. Reg. §1.988-2(a)(1). See, Cottage Savings Association v Comm'r, 499 U.S. 554 (1991). Consequently, based on the foregoing, it is more likely than not that gain or loss on such transaction would be governed by I.R.C. § 1001, and the amount realized by the purchaser would be measured with reference to the spot rate of such foreign currency on the date of the disposition.

In the case of a transaction described in I.R.C. § 988 entered into by an individual, I.R.C. § 988(e) provides that the rules of I.R.C. § 988 apply only to the extent that expenses properly allocable to the transaction meet the requirement of I.R.C. §§ 162 or 212 (other than that part of I.R.C. § 212 dealing with expenses incurred in connection with taxes). I.R.C. § 162 relates to expenses incurred in a trade or business and I.R.C. § 212 applies to expenses incurred in the production of income. See. Treas. Reg. § 1.988-1(a)(9)(i) and (ii), Example 1.

⁵ Treas. Reg. § 1.988-2(a)(1)(iii) provides, however, that the deposit of nonfunctional currency in a demand or time deposit or similar instrument (such as a certificate of deposit) issued by a bank or other financial institution and denominated in the same nonfunctional currency does not trigger recognition of exchange gain or loss.

Assuming that the purchaser uses the U.S. dollar as the purchaser's functional currency, the disposition of the foreign currency is a transaction that is treated as a "Section 988 transaction" on which gain or loss is recognized. I.R.C. § 988(c)(1)(C). Under I.R.C. § 988(a)(1) and Treas. Reg. § 1.988-3(a), such gain or loss is treated as ordinary income or loss.

Treas. Reg. § 1.988-2 provides rules for determining the amount of gain or loss that arises from a Section 988 transaction and that is characterized as ordinary under Treas. Reg. § 1.988-3. Treas. Reg. § 1.988-2(a)(2)(i) provides that on a disposition of a nonfunctional foreign currency the exchange gain is the entire amount of the excess of the amount realized over the adjusted basis in the currency and the amount of exchange loss is the entire amount of the excess of the taxpayer's adjusted basis in the currency over the amount realized on its disposition. Treas. Reg. § 1.988-2(a)(2)(ii) provides that the amount realized on the disposition of a non-functional currency is determined under I.R.C. § 1001, and Treas. Reg. § 1.988-2(c)(2)(iii)(A) provides that the adjusted basis of a nonfunctional currency is determined under the applicable provisions of the Code.

Treas. Reg. § 1.988-1(a)(11) gives the IRS the power to exclude a transaction from the provisions of I.R.C. § 988 if the substance of the transaction or transactions indicates that the transactions are not properly considered section 988 transactions. There is no guidance under Treas. Reg. § 1.988-1(a)(11) as to what would not properly be considered an I.R.C. § 988 transaction. Some insight may be gained from the example in the Regulation, which deals with the reverse situation. In the example, the taxpayer transfers nonfunctional currency to a newly formed corporation with no other assets and sells the stock, claiming that the transaction is not a section 988 transaction. In the example, the Commissioner recharacterized the transaction as being a section 988 transaction because an asset not subject to I.R.C. § 988, the stock, was substituted for an asset that is subject to I.R.C. § 988. In the instant case, the purchaser acquired the Assets in a transaction described in Treas. Reg. § 1.988-1(a)(1) and -2(a)(1). The acquisition of the Assets is not the surrogate for a transaction involving an asset not described in I.R.C. § 988. Based on the foregoing, it is more likely than not that the IRS would not be successful were it to attempt to recharacterize the transaction under Treas. Reg. § 1.988-1(a)(11).

Treas. Reg. § 1.988-2(f) gives the Commissioner the power to recharacterize the timing, source, and character of gains and losses with respect to a section 988 transaction in accordance with its substance. The example in the Regulation involves a taxpayer who denominated a transaction that was in substance a forward sales contract as a notional principal contract and who attempted to apply the rules relating to notional principal contracts to the transactions. In the instant case, the acquisition and disposition of the Assets are reported consistently with the form of the transactions and consistently with their economic substance. Consequently, it is more likely than not that the IRS would not be

successful were it to attempt to change the timing, character or source of the loss recognized by the purchaser from engaging in the Transactions.

Treas. Reg. § 1.988-2(a)(1)(i) provides that the recognition of gain or loss from the sale or disposition of a nonfunctional currency is governed by the other provisions of the Code that apply to the sale or disposition of property, and cites I.R.C. §§ 1001 and 1092 as examples of such provisions. Treas. Reg. § 1.988-2 does not, however, specifically refer to I.R.C. § 165 in connection with the allowance of a deduction of a loss sustained under I.R.C. § 988. Consequently, there is some uncertainty as to whether I.R.C. § 988 independently provides for the allowance of a loss sustained in a Section 988 transaction or whether such loss must also be tested under I.R.C. § 165. The language of I.R.C. § 988(a)(1) to the effect that, notwithstanding any other provisions of the Code, a loss sustained in a Section 988 transaction shall be treated as an ordinary loss, supports the view that I.R.C. § 988 provides an independent allowance. This position is further supported by I.R.C. § 988(e), which limits losses incurred by an individual to those incurred in transactions in which expenses allocable to the transaction would be deductible under I.R.C. §§ 162 or 212. Because the individual loss allowance rules of I.R.C. § 165(c) contain provisions that are substantially the same, if I.R.C. § 988 losses of an individual were subject to I.R.C. § 165(c) there would have been no need to include similar limitations with I.R.C. § 988(e). Thus, although the law is not entirely clear, it is more likely than not that I.R.C. § 988 would be viewed as providing for the deduction of a loss from an I.R.C. § 988 transaction independently of I.R.C. § 165.

Even were the IRS to successfully contend that a loss recognized under I.R.C. § 988 must meet the requirements of I.R.C. § 165, the loss should still be deductible in the instant case. This is because I.R.C. § 165(b) calculates the amount of deduction based on the adjusted basis rules of I.R.C. § 1011, which equally apply under Treas. Reg. § 1.988-2(a). Furthermore, as discussed below, were the loss claimed by the purchaser in his individual return, we believe that it is more likely than not that the I.R.C. § 165(c) standard would be met.

Notwithstanding this general statutory language relating to I.R.C. § 165, Treas. Reg. § 1.165-1 (b) provides that, for the loss to be allowable under I.R.C. § 165(a), the loss must be evidenced by closed and completed transactions, fixed by identifiable events, and be actually sustained during the taxable year, that the loss be a bona fide loss; and that substance rather than form should govern. As discussed above, the loss on the Assets is evidenced by closed and completed events and fixed by an identifiable event, their expiration. Consequently, it is more likely than not that the IRS would be unsuccessful were it to attempt to deny under I.R.C. § 165 the deduction of a loss recognized by the purchaser with respect to the options under I.R.C. § 988.

Based on the forgoing, if the purchaser disposes of the foreign currency acquired from LLC at a gain or loss, it is more likely than not that the entire amount of such

gain or loss would constitute ordinary income or ordinary loss under I.R.C. § 988 and Treas. Reg. § 1.988-3(a).

5	Does the “loan” to the LLC constitute genuine indebtedness for Federal income tax purposes?
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The Government’s Position

The purported loan to the LLC does not constitute genuine indebtedness and therefore the taxpayer’s subsequent assumption of that indebtedness has no effect for Federal income tax purposes.

A loss is allowable as a deduction for Federal income tax purposes only if it is bona fide and reflects actual economic consequences. See generally, Gregory v. Helvering, 293 U.S. 465 (1935); Freytag v. Commissioner, 904 F.2d 1011, 1015 (5th Cir. 1990). In certain circumstances, courts will recognize that, even if a transaction actually does occur, that transaction may be lacking in economic substance. Lerman v. Commissioner, 939 F.2d 44, 49 n.6 (3d Cir. 1991). See also, Yosha v. Commissioner, 861 F.2d 494, 500 (7th Cir. 1988).

For instance, with respect to transactions involving loans, “it is well settled that the mere fact that a note is given does not prove the existence of a loan where there was no indebtedness existing which the note evidenced.” Leonard v. Commissioner, T.C. Memo. 1985-51, citing Elbert v. Commissioner, 45 B.T.A. 685 (1941), and Golsen v. Commissioner, 54 T.C. 742, 754 (1970), aff’d, 445 F.2d 985 (10th Cir. 1971). In Knetsch v. Commissioner, 364 U.S. 361 (1960), the Supreme Court held that a loan transaction entered into by a taxpayer may be disregarded for tax purposes if there was no genuine indebtedness. The Supreme Court held that no valid indebtedness existed where the taxpayer never acquired a meaningful beneficial interest in the loan. In Bridges v. Commissioner, 39 T.C. 1064, aff’d, 325 F.2d 180 (4th Cir. 1963), a taxpayer purportedly borrowed funds from banks to buy Treasury notes and bonds which were pledged as collateral to secure the loans with the proceeds upon maturity or resale being applied to the repayment of the loans. The court described the transaction as merely providing the “facade” of a loan because the taxpayer never had control of the funds purportedly borrowed or the collateral (the Treasury notes and bonds), and the collateral amply secured the purported loan.

In the typical Notice 2002-21 transaction, the facts and circumstances of the loan transaction support the conclusion that the credit arrangement lacks economic substance.⁶ On the original loan date, the lender purportedly transfers funds to the borrower. Contemporaneously with this “transfer,” however, the entire loan proceeds are then deposited into a collateral account held by the lender. Per the

⁶ This argument must be supported by facts showing that neither LLC nor taxpayer obtained use of “borrowed” funds. Such facts would include lack of control over property held in the collateral accounts and the inability to substitute collateral.

loan agreement, the borrower assigned all its rights in the collateral account back to the lender. Therefore, borrower never obtained unfettered use of or control over the borrowed funds.

Similarly, the transfer of a portion of the loan proceeds to the taxpayer pursuant to the subsequent purchase agreement mirrors the same circular flow described above. Here, the typical taxpayer "acquires" approximately 15% of the loan amount, and again the entire amount is re-deposited with the original lender. The taxpayer is also required to assign all of its rights in this second collateral account to the lender. The only substantive change following taxpayer's assumption is that a portion of the loan collateral has been transferred to the taxpayer's collateral account from one of the LLC's collateral accounts.

Usually when the collateral accounts are established, the original borrower and the assuming party are required to deposit additional collateral into their respective accounts. The total collateral deposits (loan proceeds, additional collateral, plus any accrued interest) provide funds sufficient to satisfy interest payments as they become due on the loan through the first re-set date. Accordingly, the loan is fully collateralized and economically defeased up to that point. In substance, the bank never relinquishes control of the "borrowed" funds and is protected from any credit risk because it holds sufficient funds in the collateral accounts to satisfy the loan obligations. The bank simply makes offsetting bookkeeping entries debiting the appropriate amount from the collateral accounts and applying these funds to pay the interest due on the loan. At no time does the original borrower (or the taxpayer) obtain the unfettered use of any additional money as a result of the credit agreement. Since the borrower incurs no genuine indebtedness, the purported assumption of such indebtedness by taxpayer has no effect for tax purposes.

The Taxpayers' Position

Taxpayers argue that, for the following reasons, it is more likely than not that the loan would be treated as debt for Federal income tax purposes.

The taxpayers point to the following factors considered by the courts and the factors in their transactions in concluding that the loan would be treated as debt for Federal income tax purposes:

	<u>Factors Considered by the Courts</u>	<u>Factors in the CARDS Transaction</u>
1	Whether the instrument has a fixed maturity date	The loan has a fixed maturity date
2	Whether the return paid with respect to the instrument is contingent on the earnings or	Payments on the loan are not contingent on the earnings of the LLC

- assets of the issuer
- 3 Whether the holder of the instrument has typical shareholder's or creditor's rights In the event of a default, the bank has all the typical creditor's rights.
- 4 Name given to the instrument The loan is documented as debt
- 5 Intent of the parties The parties have agreed in the Loan Agreement to treat the loan as debt

6	May the taxpayer's loss and transaction costs be disallowed because the transaction as a whole lacks economic substance and business purpose apart from tax savings?
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The Government's Position

The taxpayer's claimed loss is not allowable because the transaction as a whole lacks economic substance and business purpose apart from tax savings.

To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits, which were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 2001), aff'g 113 T.C. 254 (1999); United States v. Wexler, 31 F.3d 117, 122, 124 (3rd Cir. 1994); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2nd Cir. 1966), aff'g 44 T.C. 284 (1965); Weller v. Commissioner, 31 T.C. 33 (1958), aff'd 270 F.2d 294 (3rd Cir. 1959); Nicole Rose Corp. v. Commissioner, 117 T.C. 328 (2001); ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3rd Cir. 1998).

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership v. Commissioner, 157 F.3d at 247; Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990).

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). In Knetsch, the taxpayer repeatedly borrowed against increases in the cash value of a bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

In Sheldon v. Commissioner, 94 T.C. 738 (1990), the Tax Court denied the taxpayer the tax benefits of a series of Treasury bill sale-repurchase transactions because they lacked economic substance. In the transactions, the taxpayer bought Treasury bills that matured shortly after the end of the tax year and funded the purchase by borrowing against the Treasury bills. The taxpayer accrued the majority of its interest deduction on the borrowings in the first year while deferring the inclusion of its economically offsetting interest income from the Treasury bills until the second year. The transactions lacked economic substance because the economic consequence of holding the Treasury bills was largely offset by the economic cost of the borrowings. The taxpayer was denied the tax benefit of the transactions because the real economic impact of the transactions was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions." Sheldon v. Commissioner, 94 T.C. at 769.

In ACM Partnership, the taxpayer entered into a near-simultaneous purchase and sale of debt instruments. Taken together, the purchase and sale "had only nominal, incidental effects on [the taxpayer's] net economic position." ACM Partnership v. Commissioner, 157 F.3d at 250. The taxpayer claimed that, despite the minimal net economic effect, the transaction had economic substance. The court held that transactions that do not "appreciably" affect a taxpayer's beneficial interest, except to reduce tax, are devoid of substance and are not respected for tax purposes. Id. at 248. The court denied the taxpayer the purported tax benefits of the transaction because the transaction lacked any significant economic consequences other than the creation of tax benefits. But Cf. Compaq Computer Corp v. Commissioner, 277 F.3d 778 (5th Cir. 2001), 2002-1 USTC ¶ 50,144 rev'g 113 T.C. 214 (1999) [stating that a "taxpayer's subjective intent to avoid taxes ... will not by itself determine whether there was a business purpose to a transaction" and that steps to avoid risk may show "good business judgment consistent with a subjective intent to treat ... trade as a money-making transaction."]

Even if the purported loan to the LLC constitutes genuine indebtedness of the LLC, it likely can be shown that the Notice 2002-21 transaction lacks economic substance. Facts indicating that the transaction fails the objective prong of the economic substance test include large transaction costs that the taxpayer is unlikely to recover given the small, if any, spread between earnings on collateral and the interest rate on the underlying loan, lack of control over the property

pledged as collateral and an inability to substitute collateral, and the short period of time before the transaction is terminated through repayment of the loan. These facts all demonstrate lack of any reasonable potential for pre-tax profit.⁷

Generally, the transaction also fails the subjective economic substance prong. Typically, the taxpayer has significant taxable income (either capital gain income or ordinary income) unrelated to the transaction. Through participation in this transaction, the taxpayer is able to choose the character and amount of the loss needed to offset the unrelated income. The close connection between the taxable income being sheltered and the claimed loss suggests that the taxpayer did not enter into this transaction for a business purpose. As the Tenth Circuit has recognized, "correlation of losses to tax needs coupled with a general indifference to, or absence of, economic profits may reflect a lack of economic substance." Keeler v. Commissioner, 243 F.3d 1212, 1218 (10th Cir. 2001), citing Freytag v. Commissioner, 89 T.C. 849, 877-878 (1987). Here, the taxpayer could have borrowed funds directly from a financial institution. Instead, with the assistance of a tax shelter promoter, the taxpayer chose to acquire its investment in such a manner as to exploit the assumption of liability rules. There was no useful non-tax purpose for entering into this structured transaction and certain steps thereto other than the creation of an artificial tax loss. In conclusion, there is no practical economic effect from the transaction, in whole or in part, other than the creation of a loss to offset unrelated taxable income. Accordingly, any tax benefits, fees or expenses, related thereto, may be disallowed because the Notice 2002-21 transaction as a whole lacks economic substance and business purpose apart from tax savings.

Taxpayers' Position

The taxpayers argue that their transactions may not be disallowed because the transactions, as a whole, do not lack economic substance and business purpose apart from tax savings:

- | | | |
|---|--|--|
| 1 | Sham Transaction Doctrine | |
| a | Shams in fact | Every transaction did in fact occur as described |
| b | Sham in substance
Taxpayers fully protected against loss through arrangements and the transactions were structured so that the taxpayers could not earn a profit from them. | Neither the taxpayer nor the LLC entered into arrangements that voided the economic effects of any of the transactions |

⁷ Facts demonstrating that a transaction lacks any reasonable possibility of pre-tax profit should be developed prior to arguing lack of economic substance.

- 2 **Economic Substance**
A transaction must have economic substance separate and distinct from the economic benefit derived from tax savings
- Discussing various court cases and specifically Northern Indiana Public Service Corporation v. Commissioner, 105 T.C. 341 (1995) aff'd 115 F.3d 506 (7th Cir. 1997), the taxpayers argue that the tax benefits achieved in a transaction should not be denied under the economic substance doctrine merely because the transaction's principal purpose was to achieve such tax benefits.
- 3 **Business Purpose**
For a transaction to have a business purpose, there must be a business reason for the taxpayer to engage in the transaction without regard to tax benefits.
- The taxpayers argue that they have a business purpose in entering into the transactions without regard to tax benefits.
- In one specific case, the taxpayer argues that the purchase of inventory in the subject transaction was needed in its trade or business and that through the transaction the taxpayer hoped to centralize its purchase of inventory.

**Issue 1
An Assessment of the Litigating Hazards
and the
Appeals Settlement Guidelines**

For the reasons set forth below, it is our determination that the taxpayers have failed to show that the transactions described above result in a deductible loss.

[REDACTED]

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Our determinations and conclusions are based on the following factors:

1 The taxpayers have failed to provide documentary evidence that the transactions establish a reasonable profit potential in excess of the associated fees with respect to the transaction

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2 This transaction was designed as a product to shelter income.

3 The law and rulings with regard to I.R.C. § 1012 provide that the inclusion of liabilities in basis by a buyer is predicated on the assumption that the liabilities will be paid in full by the buyer. Commissioner v. Tufts, 461 U.S. 300, 308 (1983).

That rationale is absent in Notice 2002-21 transactions. In the absence of direct authority, a supportable method of allocating basis looks to the amount of the total debt that each co-obligor can be expected to pay. In the Notice 2002-21 transaction, as a matter of economic reality, the parties by agreement have bifurcated the loan into two parts: (1) interest with the LLC as the primary obligor and thus expected to pay; and (2) principal with the taxpayer as the primary obligor and thus expected to pay. Each will bear responsibility for repayment of the loan in accordance with their relative ownership of the collateral immediately following the transfer from LLC to the taxpayer. Accordingly, the taxpayer's basis in the assets is equal to their fair market value upon their acquisition by taxpayer, i.e., the taxpayer's basis should be limited to the fair market value of the assets received rather than the full loan amount.

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[REDACTED]

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[REDACTED]

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5 As noted above, the taxpayers argue that decided cases have established that a taxpayer need only have a good faith expectation of earning a profit from the activities undertaken. See, e.g., Burger v. Comm'r, 809 F.2d 355 (7th Cir. 1987); Johnson v. U.S., 11 Cl. Ct. 17 (1986). Further, the taxpayers argue if an individual incurs a loss from the sale of assets in a transaction which does not involve the individual's trade or business, I.R.C. § 165(c)(2) and Treas. Reg. § 1.165-1(e) nonetheless allow deduction of the loss because it results from a transaction entered into for profit.

The taxpayers have failed to show, however, that their investment in the CARDS transaction was entered into for profit.

The application of I.R.C. § 165(c) does not require success in the government's argument that the transaction lacks economic substance.

[REDACTED]

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By citing Farmer v. Commissioner, T.C. Memo. 1994-342, the taxpayer first appears to be arguing that its loss is deductible under I.R.C. § 165(c)(1), because it was organized to engage in a trade or business for profit within the meaning of I.R.C. § 183. Farmer indicates that, in determining whether a loss is deductible under I.R.C. § 165(c)(1), it is necessary to ascertain whether the taxpayer was organized to engage in a business for profit within the meaning of I.R.C. § 183.

In the CARDS transaction, the taxpayer is not engaged in a trade or

business within the meaning of section 165(c)(1). A single transaction

does not constitute a trade or business. To be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity. Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987). The taxpayer’s investment in the transaction was neither a continuous nor a regular activity. In addition, as discussed below, taxpayer was not engaged in a trade or business with expectation of profit within the meaning of I.R.C. § 165(c)(1).

[REDACTED]

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The taxpayers also argue that, under I.R.C. § 183, for purposes of I.R.C. §§ 162, 183, and 212, a profit motive exists if the taxpayer has a good faith expectation of earning a profit from the activity. See, e.g., Burger v. CIR, 809 F. 2d 355, 358 (7th Cir. 1987); see also I.R. C. § 1.183-2(a) of the Income Tax Regulations. The taxpayer’s argument seems to be that, because of the subjective nature of the profit motive requirement, a taxpayer’s statement that it expects to profit should in most circumstances satisfy the test.

[REDACTED]

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I.R.C. § 183(a) states that, in the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section. I.R.C. § 183(c) defines “activity not engaged in for profit” as any activity other than one with respect to which deductions are allowed for the taxable year under I.R.C. §§ 162 or 212(1) or (2).

While I.R.C. § 183 does not make any reference to the profit motive determination for purposes of I.R.C. § 165(c)(2), generally, I.R.C. § 212 is complementary to I.R.C. § 165(c)(2). See Boris I. Bittker and Lawrence Lokken, Federal Taxation of Income, Estates and Gifts, 25.3 (current through supplement No. 2 2004).

[REDACTED]

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1.183-2(b) of the regulations lists an assortment of factors that should be considered in making the determination of whether an activity is engaged in for profit. It is not intended that only the factors described therein are to be taken into account; and the determination should not be made on the basis that the number of met factors exceeds the number of unmet factors, or vice versa. The factors include: The manner in which

the taxpayer carries on the activity; the expertise of the taxpayer or his advisors; the time and effort expended by the taxpayer in carrying on the activity; the expectation that assets used in the activity may appreciate in

value; the success of the taxpayer in carrying on other similar or dissimilar activities; the taxpayer's history of income or losses with respect to the activity; the amount of occasional profits, if any, which are earned; the financial status of the taxpayer; and elements of personal pleasure or recreation.

These factors are intended to ascertain the taxpayer's intent by looking at objective facts. In its report on the Tax Reform Act of 1969, the Senate Finance Committee stated with respect to the new I.R.C. § 183: "In making the determination of whether an activity is not engaged in for profit, the committee intends that an objective rather than a subjective approach is to be employed. Thus, although a reasonable expectation of profit is not to be required, the facts and circumstances (without regard to the taxpayer's subjective intent) would have to indicate that the taxpayer entered the activity, or continued the activity, with the objective of making a profit." S. Rep. No. 91-552, at 104; reprinted in 1969-3 C.B. 490. See also § 1.183-2(a).

The factors of § 1.183-2 have been applied to tax shelters. For instance, § 1.183-2(b)(8) states that substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit. Courts have held in tax shelter cases that a comparison of the relative amounts of economic profit and expected tax benefits is relevant in determining a taxpayer's expectation of profit. See, e.g., Baron's Estate v. CIR, 83 T.C. 542, 558 (1984), aff'd, 798 F. 2d 65 (2d Cir. 1986). Other factors courts have considered in tax shelter cases include: Whether an excessive purchase price was paid for the activity's principal asset (suggesting that tax benefits, not economic profit, were the primary motivation); whether a marketing effort focused almost exclusively on tax benefits in a case in which a venture was organized and promoted by persons other than the investors; and, in some cases, the extent and effectiveness of the taxpayer's study of the activity before investing (§ 1.183-2(b)(2)). See, e.g., Beck v. CIR, 85 T.C. 557 (1985); Brannen v CIR, 722 F. 2d 695 (11th Cir. 1984).

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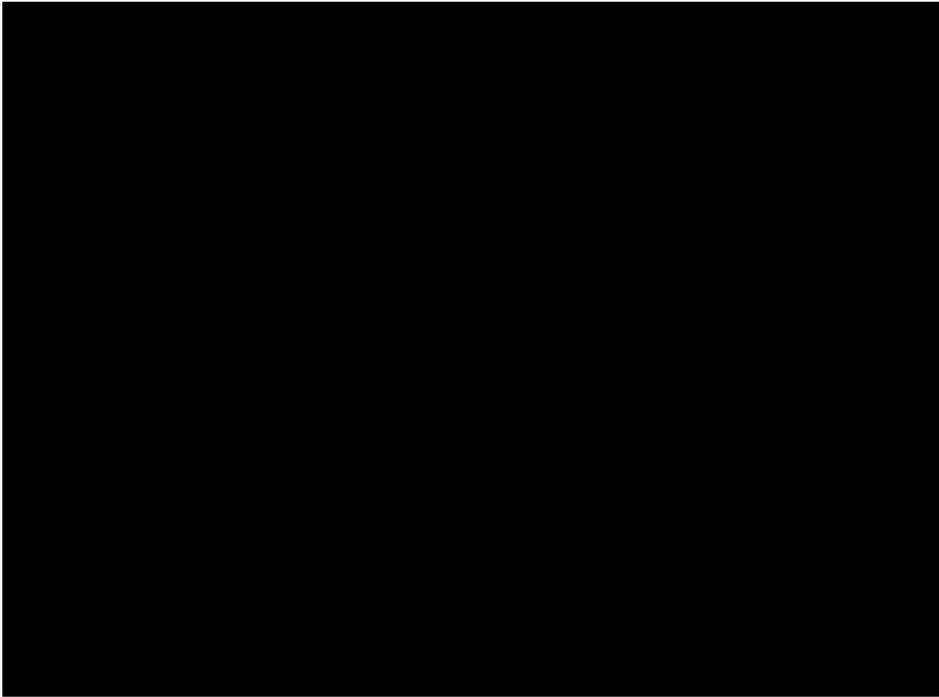
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Issue 2

Whether an accuracy-related penalty imposed by the Internal Revenue Service under the provisions of I.R.C. § 6662 against a taxpayer who invested in the CARDS transaction is appropriate.

Statement of the Issue

Section 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment⁸ 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 percent 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). See D.H.L. Corp. v. Commissioner, T.C. Memo. 1998-461, aff'd in part and rev'd on other grounds, remanded by, 285 F.3d 1210 (9th Cir. 2002) (The Service alternatively determined that either the 40-percent accuracy-related penalty attributable to a gross valuation misstatement under I.R.C. § 6662(h) or the 20-percent accuracy-related penalty attributable to negligence was applicable).

Issue 2 Discussion and Analysis

The Government's Position

The Service has discussed the law and arguments in support of the imposition of a penalty in four separate sections. These sections are as follows:

- ? Negligence or Disregard of the Rules and Regulations
- ? Substantial Understatement
- ? Substantial Valuation Misstatement
- ? Reasonable Cause Pursuant to I.R.C. § 6664

Negligence or Disregard of Rules or Regulations

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

⁸ For purposes of I.R.C. § 6662, the term "underpayment" is generally the amount by which the taxpayer's correct tax is greater than the tax reported on the return. See I.R.C. § 6664(a).

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 (5th Cir. 1967), aff'd, 43 T.C. 168 (1964); Neely v. Commissioner, 85 T.C. 934, 947 (1985). 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, therefore, a taxpayer reported losses from a transaction that lacked economic substance without making a reasonable attempt to ascertain the correctness of the claimed losses, then the accuracy related penalty attributable to negligence may be appropriate. For example, in Compaq v. Commissioner, 113 T.C. 214 (1999), rev'd on other grounds, 277 F.3d 778 (5th Cir. 2001), the Service argued that Compaq was liable for the accuracy-related penalty because Compaq disregarded the economic substance of the transaction. The court agreed with the Service's position and upheld the accuracy-related penalty for negligence because Compaq failed to "investigate the details of the transaction, the entity it was investing in, the parties it was doing business with, or the cash-flow implications of the transaction." Compaq v Commissioner, 113 T.C. at 227.

"Disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. A disregard of rules or regulations is "careless" if the taxpayer does not exercise reasonable diligence in determining whether a position taken on its return 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).

"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 the 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. Treas. Reg. § 1.6662-3(c)(1). Moreover, 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).

Substantial Understatement

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 for a corporation, other than an S corporation or a personal holding company). I.R.C. § 6662(d)(1). There are specific rules that apply to the calculation of the understatement when any portion of the understatement arises from an item attributable to a tax shelter. For purposes of § 6662(d)(2)(C), a tax shelter is a partnership or other entity, an investment plan or arrangement, or other plan or arrangement where a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax. I.R.C. § 6662(d)(2)(C)(iii). Because the purpose of the Notice 2002-21 plan is tax avoidance, it is a tax shelter pursuant to I.R.C. § 6662(d)(2)(C). Different rules apply, however, depending upon whether the taxpayer is a corporation or an individual or entity other than a corporation.

In the case of any item of a taxpayer other than a corporation which is attributable to a tax shelter, understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority⁹ for such treatment, if (2) the taxpayer reasonably believed that the tax treatment of the item was more likely than not the proper treatment. I.R.C. § 6662(d)(2)(C)(i). A taxpayer is considered to have reasonably believed that the tax treatment of an item is more likely than not the proper tax treatment if (1) the taxpayer analyzes the pertinent facts and authorities, and based on that analysis reasonably concludes, in good faith, that there is a greater than fifty-percent likelihood that the tax treatment of the item will be upheld if the Service challenges it, or (2) the taxpayer reasonably relies, in good faith, on the opinion of a professional tax advisor, which clearly states (based on the advisor's analysis of the pertinent facts and authorities) that the

⁹ There is substantial authority for the tax treatment of an item only if the weight of authorities supporting the treatment is substantial in relation to the weight of the authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. Treas. Reg. § 1.6662-3(d)(i). On the basis of the substantive discussion of the Notice 2002-21 transaction in the foregoing pages of this document, it is unlikely that the transaction would meet the substantial authority test.

advisor concludes there is a greater than fifty percent likelihood the tax treatment of the item will be upheld if the Service challenges it. Treas. Reg. § 1.6662-4(g)(4).

It is well established that taxpayers generally cannot "reasonably rely" on the professional advice of a tax shelter promoter. See Neonatology Associates, P.A., v. Commissioner, 299 F.2d 221 (3rd Cir. 2002) (citing Ellwest Stereo Theatres of Memphis, Inc. v. Commissioner, T.C. Memo. 1995-610). ("Reliance may be unreasonable when it is 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."); Goldman v. Commissioner, 39 F.3d 402, 408 (2d Cir. 1994) ("Appellants cannot reasonably rely for professional advice on someone they know to be burdened with an inherent conflict of interest."), aff'g, T.C. Memo 1993-480; Marine v. Commissioner, 92 T.C. 958, 992-993 (1989), aff'd without published opinion, 921 F.2d 280 (9th Cir. 1991). Such reliance is especially unreasonable when the advice would seem to a reasonable person to be "too good to be true". Pasternak v. Commissioner, 990 F.2d 893, 903 (6th Cir. 1993), aff'g, Donahue v. Commissioner, T.C. Memo. 1991-181; Gale v. Commissioner, T.C. Memo. 2002-54; Elliott v. Commissioner, 90 T.C. 960, 974 (1988), aff'd without published opinion, 899 F.2d 18 (9th Cir. 1990); Treas. Reg. § 1.6662-3(b)(2). Thus, if the taxpayer claimed to have relied on a tax opinion from a promoter, the understatement penalty would likely apply. Further, if the taxpayer did not receive the opinion until after filing the return, the taxpayer could not have relied upon the tax opinion in taking a position on the return. Thus, the understatement could not be reduced.

In the case of items of corporate taxpayers no provision applies to reduce the understatement on the basis of the taxpayer's position or disclosure of items. 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 (such as a Notice 2002-21 transaction), the accuracy-related penalty applies to the underpayment arising from the understatement unless the reasonable cause and good faith exception applies.

Substantial 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 for 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 percent penalty under I.R.C. § 6662(a) is increased to 40 percent. 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. See Gilman v. Commissioner, 933 F.2d 143 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992) (applying § 6659, repealed and replaced by § 6662); Zfass v. Commissioner, 118 F.3d 184 (4th Cir. 1997), aff'g, T.C. Memo. 1996-167; Illes v. Commissioner, 976 F.2d 733 (6th Cir. 1992), aff'g, T.C. Memo. 1991-449; Massengill v. Commissioner, 876 F.2d 616 (8th Cir. 1989), aff'g, T.C. Memo. 1988-427. But see Gainer v. Commissioner, 893 F. 2d 225 (9th Cir. 1990); Todd v. Commissioner, 862 F.2d 540 (5th Cir. 1988). (The Courts viewed the underpayment as attributable to an improper deduction, not a valuation misstatement). If the taxpayer's claimed basis in the assets is 200 percent or more of the correct amount, then a substantial valuation misstatement exists; if the claimed basis in the assets is 400 percent or more of the correct amount, then a gross valuation misstatement exists. In many cases, the basis overstatement will be of such a magnitude that a gross valuation misstatement penalty will be appropriate pursuant to I.R.C. § 6662(h).

Reasonable Cause Pursuant To I.R.C. § 6664

I.R.C. § 6664(c) provides an exception, applicable to all types of taxpayers, to the imposition of any accuracy-related penalty if the taxpayer shows that there was reasonable cause and the taxpayer acted in good faith. Special rules, described below, apply to items of a corporation attributable to a tax shelter resulting in a substantial understatement.

The determination of whether the taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all relevant facts and circumstances. See Treas. Reg. § 1.6664-4(b)(1) and (f)(1). 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.

On December 30, 2003, Treasury and the Service amended the I.R.C. § 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 I.R.C. § 6011. 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.

Generally, the most important factor in determining whether the taxpayer has reasonable cause and acted in good faith is the extent of the taxpayer's effort to assess the proper tax liability. See Treas. Reg. § 1.6664-4(b)(1); see also Larson v. Commissioner, T.C. Memo. 2002-295; Estate of Simplot v. Commissioner, 112 T.C. 130, 183 (1999) (citing Mandelbaum v. Commissioner, T.C. Memo. 1995-255), rev'd on other grounds, 249 F.3d 1191 (9th Cir. 2001). For example, reliance on erroneous information reported on an information return indicates reasonable cause and good faith, provided that the taxpayer did not know or have reason to know that the information was incorrect. Similarly, an isolated computational or transcription error is not inconsistent with reasonable cause and 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 (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).

Reliance upon a tax opinion provided by a professional tax advisor may serve as a basis for the reasonable cause and good faith exception to the accuracy-related penalty. The reliance, however, must be objectively reasonable, as discussed more fully below. For example, the taxpayer must supply the professional with all the necessary information to assess the tax matter. The advice also must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances.

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 which 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. See Treas. Reg. § 1.6662-4(g)(4)(ii).

Where a tax benefit depends on nontax factors, the taxpayer has a duty to investigate the underlying factors rather than simply relying on statements of another person, such as a promoter. See Novinger v. Commissioner, T.C. Memo. 1991-289. Further, if the tax advisor is not versed in these nontax matters, mere reliance on the tax advisor does not suffice. See Addington v. United States, 205 F.3d 54 (2d Cir. 2000); Collins v. Commissioner, 857 F.2d 1383 (9th Cir. 1988); Freytag v. Commissioner, 89 T.C. 849 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990).

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, 39 F.3d 402 (2nd Cir. 1994). See also Neonatology Associates, P.A. v. Commissioner, 299 F.3d 221 (3rd Cir. 2002)(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); Gilmore & Wilson Construction Co. v. Commissioner, 99-1 U.S.T.C. ¶ 50,186 (10th Cir. 1999) (taxpayer liable for negligence since reliance on representations of the promoters and offering materials unreasonable); Roberson v. Commissioner, 98-1 U.S.T.C. ¶ 50,269 (6th Cir. 1998) (court dismissed taxpayer's purported reliance on advice of tax professional because of professional's status as "promoter with a financial interest" in the investment); Pasternak v. Commissioner, 990 F.2d 893, 903 (6th Cir. 1993)(finding reliance on promoters or their agents unreasonable, as "advice of such persons can hardly be described as that of 'independent professionals'"); Illes v. Commissioner, 982 F.2d 163 (6th Cir. 1992) (taxpayer found negligent; reliance upon professional with personal stake in venture not reasonable); Rybak v. Commissioner, 91 T.C. 524, 565 (1988) (negligence penalty sustained where taxpayers relied only upon advice of persons who were not independent of promoters).

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, T.C. Memo.

1996-341, aff'd, 98-1 USTC ¶ 50,108 (2d Cir. 1997). 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, T.C. Memo. 1996-341, aff'd, 98-1 U.S.T.C ¶ 50,108 (2d Cir. 1997).

If a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy-related penalty applies to that portion of the understatement unless the reasonable cause and good faith exception applies. 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 in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but only 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)(B).

The reasonable belief standard is met 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 who analyzed all the pertinent facts and authorities, and who unambiguously states that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by IRS. (See Treas. Reg. § 1.6664-4(c) for requirements with respect to the opinion of a professional tax advisor upon which the foregoing discussion elaborates).

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).

Lastly, for purposes of the substantial valuation penalty, the fact that the value of property has been appraised does not ordinarily indicate reasonable cause and good faith. Other factors to consider include: (1) the methodology and assumptions underlying the appraisal; (2) the appraised value; (3) the relationship between appraised value and purchase price; (4) the circumstances under which the appraisal was obtained; and (5) the appraiser's relationship to the taxpayer or to the activity in which the property is used. Treas. Reg. § 1.6664-4(b)(1). When considering an appraisal as an aspect of reasonable cause and good faith in a Notice 2002-21 transaction, particular attention should be paid to factors (3), (4), and (5).

The Taxpayers' Position

As noted above, taxpayers believe that the CARDS transaction is a valid transaction and that it, more likely than not, would withstand challenges by the Government.

The taxpayers argue:

- ? There was substantial authority for the tax treatment of the item
- ? The taxpayer reasonably believed at the time the return was filed the tax treatment of that item was more likely than not the proper treatment
- ? The taxpayers showed that there was a reasonable cause for, and the taxpayer acted in good faith with respect to, the tax treatment of the item.

Compliance has identified the CARDS transaction in partnership returns. Special rules apply in transactions involving a partnership subject to the unified partnership audit and litigation procedures of I.R.C. §§ 6221 through 6234 (which may occur, for example, where the taxpayer forms a partnership that participates directly in the transaction). For taxable years ending after August 5, 1997, penalties may be determined at the partnership level. I.R.C. § 6221. Treas. Reg. § 301.6221-1, effective for years ending after October 3, 2001, provides as follows:

(c) Penalties determined at partnership level. Any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item shall be determined at the partnership level. Partner-level defenses to such items can only be asserted through refund actions following assessment and payment. Assessment of any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item shall be made based on partnership-level determinations. Partnership-level determinations include all the legal and factual determinations that underlie the determination of any penalty, addition to tax, or additional

amount, other than partner-level defenses specified in paragraph (d) of this section.

(d) Partner-level defenses. Partner-level defenses to any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item may not be asserted in the partnership-level proceeding, but may be asserted through separate refund actions following assessment and payment. See I.R.C. § 6230(c)(4). Partner-level defenses are limited to those that are personal to the partner or dependent upon the partner's separate return and cannot be determined at the partnership level. Examples of these determinations are whether any applicable threshold underpayment of tax has been met with respect to the partner or whether the partner has met the criteria of I.R.C. § 6664(b) (penalties applicable only where return is filed), or I.R.C. § 6664(c)(1) (reasonable cause exception) subject to partnership-level determinations as to the applicability of I.R.C. § 6664(c)(2).

Following prior partnership law with respect to partnership items, relevant inquiries into tax motivation and negligence with respect to partnership level determinations of penalties should be determined with reference to the state of mind of the general partner. See Wolf v. Commissioner, 4 F.3d 709, 713 (9th Cir. 1993); Fox v. Commissioner, 80 T.C. 972, 1008 (1983), aff'd 742 F.2d 1441 (2nd Cir. 1984); aff'd sub nom. Barnard v. Commissioner, 731 F.2d 230 (4th Cir. 1984); Zemel v. Commissioner, 734 F.2d 5-9 (3rd Cir. 1984). Nevertheless, to the extent the general partner essentially acted as the alter ego of the taxpayer, the taxpayer's intent is relevant in this context.

Partner-level defenses may only be raised through subsequent partner-level refund suits. See Treas. Reg. §§ 301.6221-1(d) and 301.6231(a)(6)-3. Good faith and reasonable cause of individual investors pursuant to I.R.C. § 6664 would be the type of partner level defense that can be raised in a subsequent partner-level refund suit. However, to the extent that the taxpayer effectively acted as the general partner and that the intent of the general partner is determined at the partnership level, it is likely that such partnership level determinations may also dispose of partner-level defenses under the unique facts of each case.

(ii) Whether the unified partnership audit and litigation procedures of I.R.C. §§ 6221 through 6234 apply to the tax shelter adjustments.

If the shelter adjustments at issue are generated by a TEFRA partnership, then the income and deductions of the partnership can only be adjusted under the unified partnership audit and litigation procedures of I.R.C. §§ 6221 through 6234. In addition to income, deductions and credits of the partnership, the TEFRA procedures would also apply to any reallocation of partnership items including any reallocation under I.R.C. § 482. See

Treas. Reg. § 301.6231(a)(3)-1(a); Blonien v. Commissioner, 118 T.C. 541 (2002). The TEFRA procedures also apply to the determination of the amount and character (including the validity) of partnership liabilities. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(v).

Even if the deductions at issue do not flow directly from the partnership, if the taxpayer at issue is a partner in a TEFRA partnership, and received a distribution from a TEFRA partnership, the partner's carryover basis in the distributed asset is a partnership item, which must be determined under the TEFRA procedures. See Treas. Reg. § 301.6231(a)(3)-1(c)(3)(iii). Similarly, the partnership's carryover basis in any asset contributed by a partner is a partnership item. Treas. Reg. § 301.6231(a)(3)-1(c)(2)(iv).

Based on the above, if a TEFRA partnership is used to implement a Notice 2002-21 transaction, the various components of the transaction should be reviewed to determine if any portion of the adjustments will require the initiation of a TEFRA partnership proceeding.

If the TEFRA partnership procedures apply, certain adjustments may constitute "affected items" which cannot be adjusted prior to the completion of the TEFRA partnership proceeding. See GAF Corp v. Commissioner, 114 T.C. 519, 528 (2000). Affected items which must be asserted through an affected item notice of deficiency after the conclusion of the TEFRA proceeding include limitations of losses to a partner's basis in his partnership interest under I.R.C. § 704(d), or amount at risk under I.R.C. § 465. For corporate taxpayers, the corporation's motive under I.R.C. § 269 in acquiring the partnership interest is also an affected item.

If a TEFRA partnership is involved, the settlement of the at risk issue must be bifurcated. The transfer of amounts that affect the partner's at risk amount is addressed on Part I of the Form 870-L(AD) or Form 870-LT(AD), and the partner's ultimate amount at risk is determined in Part II of the Form.

Issue 2
An Assessment of the Litigating Hazards
and the
Appeals Settlement Guidelines

The determination of whether an accuracy-related penalty is applicable to any portion of the underpayment attributable to the Notice 2002-21 transaction is predicated upon the facts and circumstances of the taxpayer's case. Discussed above are the law, court decisions, and factors used in determining the applicability of the accuracy-related penalty. If an accuracy-related penalty is

asserted by the Government, Appeals Officers should use such law, court decisions, and factors in assessing the hazards of litigation.

Generally, taxpayers rely on opinions from one law firm to support their argument that the CARDS transaction met the tax shelter substantial authority exception provided in Treasury Regulations § 1.6662-4(g)(1).

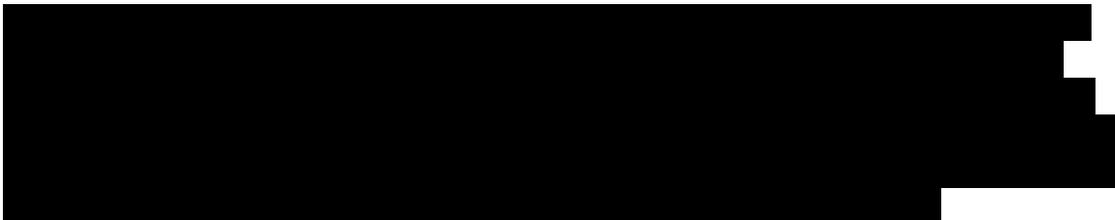
The evaluation of the hazards of litigation with regard to the reasonable cause and good faith exception to the assertion of the accuracy-related penalty must be made on a case by case basis. Factors to consider include the following:

- 1 What is the taxpayer's background, business experience and education? Does the taxpayer have any specific tax related experience, skills, or training?
- 2 How did the taxpayer get involved in the subject transaction? Who discussed it with the taxpayer and explained it to him/her? Did anyone take notes? If notes were taken, have those notes been provided to the examiner? How well did he/she understand the various aspects of the transaction? Did he/she understand how they were going to make a profit or did they rely on those who discussed it with them and explained it to them? Excluding tax savings, what did they understand the profit potential to be?
- 3 To what extent was the taxpayer influenced by tax benefits vs. investment potential? Can they quantify the percentage relationship between entering into the transaction for the tax benefit vs. entering into the transaction for investment profit potential?
- 4 Who did the taxpayer consult for either tax advice or investment advice? What did the advisors do and what advice did they give? Did the advisors give the taxpayer written advice? Did the advisors participate in meetings with the taxpayers and those who discussed and explained the transaction to them?
- 5 What was the taxpayer told about the tax opinions they would get? When did they get them? From whom did they get them?
- 6 With respect to the law firm that represented the taxpayer in the transaction, how did the taxpayer choose that law firm? Was the taxpayer familiar with the law firm? How? At what point did the taxpayer's representative begin to represent the taxpayer in this transaction?
- 7 Who were the taxpayer's investment advisors? Did the taxpayer consult with them about this transaction? Who did the taxpayer usually get tax advice from? Who prepared the taxpayer's Federal income tax returns

before and after entering into the transaction?

- 8 Did the taxpayer know or have any personal relationship with the accounting firm who set up the transaction or the legal firm that issued the opinion letter?
- 9 After the transaction started, what did the taxpayer do to monitor the transaction? Did he/she have a "checksheet" or something like it to see that the various steps were done?
- 10 Did the taxpayer believe that various parts of the transaction were separable? Did he/she think that they could have done one part without doing the rest? Once it got going, did the taxpayer believe it was "wired" in that each step was preordained and had to happen?
- 11 What is the taxpayer's investment activity? Has he/she ever engaged in anything like this transaction before that wasn't tax-advantaged? Has the taxpayer ever engaged in hedged funds, options, short selling, straddles, etc.?
- 12 Did the taxpayer use a trust or partnership intermediary? If so, why? Who suggested the use of a trust or partnership?

The taxpayer's responses to the above non-exclusive list of questions will assist in determining the hazards of litigation with respect to the taxpayer's arguments against the assertion of an accuracy-related penalty under I.R.C. § 6662(a).



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Finally, on August 27, 2004, the District Court for the district of Connecticut decided Long-Term Capital Holdings, et al.v. United States, 330 F. Supp. 2d 112 (D. Conn. 2004). The taxpayer in that case argued against the applicability of these accuracy-related penalties principally on the grounds that obtaining opinion letters satisfied the reasonable cause exception of I.R.C. § 6664(c) (1). The taxpayer also maintained that it satisfies the statutory limitations on the scope of each penalty, namely, that there is no valuation misstatement on its tax return, it did not act negligently but acted as a reasonable and prudent person, and it had substantial authority for its tax return position. The Court concluded that the IRS determination with respect to the 40% penalty for gross valuation misstatement should be sustained and, in the alternative, the 20% penalty for substantial

understatement should be sustained. Because of these findings, the Court concluded that there was no need to reach the negligence penalty issue.

It is recommended that Appeals Officers look to this District Court's discussion of the accuracy related penalty.

In reaching its decision, the Court cited the following reasons:

- ? The Government had met any burden of production it may have had, even under petitioners' view of I.R.C. § 7491(c), by coming forward with evidence demonstrating the appropriateness of penalties.
- ? The Court's application of the step transaction doctrine to the OTC transaction has the effect of imputing to the taxpayer a cost basis in the subject stock of approximately \$1 million and thereby making the taxpayer's claimed adjusted basis well in excess of 400 percent of the amount determined to be the correct adjusted basis.
- ? It is the taxpayer's burden to prove substantial authority or reasonable belief; the Government has no burden in this regard. See H.R. Conf. Rep. 105-599 at 241.
- ? The Court's determination that the taxpayer entered the OTC transaction without any business purpose other than tax avoidance and that the transaction itself did not have economic substance beyond the creation of tax benefits makes the transaction a "tax shelter" for purposes of the understatement penalty. Acquisition of the claimed basis in the subject stock was the purpose for the transaction and thus is attributable to it. See Treas. Reg. § 1.6662-4(g)(3). Accordingly, the partners of the taxpayer are not entitled to a reduction of any understatement attributable to the claimed basis and corresponding losses unless the taxpayer both had substantial authority for the claimed basis when it filed its return and a reasonable belief that more likely than not the basis was as claimed. The taxpayer had neither.
- ? Since the Court had found that the OTC transaction is devoid of objective economic substance and subjective business purpose, the taxpayer has not and cannot cite authority, much less substantial authority, for the proposition that a taxpayer may claim losses from a transaction in which the taxpayer intentionally expends far more than could reasonably be expected to be recouped through non-tax economic returns in a transaction the sole motivation for which is tax avoidance. The cases relied on by the taxpayer, principally Frank Lyon, Newman, and UPS are not authority supporting the OTC transaction as having genuine economic substance but are "materially distinguishable," Treas. Reg. § 1.6662-4(d)(3)(ii), from it.

- ? There are at least four separate grounds for concluding that the taxpayer has failed to carry its burden to show that all pertinent facts and circumstances demonstrate reasonable and good faith reliance on the advice of its advisors and therefore the taxpayer may not avoid penalties by taking refuge in I.R.C. § 6664(c).
1. The taxpayer has not satisfied its burden to prove entitlement to the reasonable cause defense as it is unable to prove the content of any advice actually received from its advisors before claiming losses from the sale of the subject stock for the purpose of showing it was based on all pertinent facts and circumstances and not on unreasonable assumptions.
 2. The Court, assuming, arguendo, that the advisors' written opinion dated January 27, 1999, had been provided to the taxpayer prior to April 15, 1998, the taxpayer cannot prove that such advice meets the threshold requirements for reasonable good faith reliance, and the preponderance of evidence otherwise does not demonstrate that the taxpayer reasonably relied in good faith on its advisors' advice.
 3. There was other evidence in the record suggesting the absence of reasonable good faith reliance on legal advice. One partner discussed the advisor's advice with other partners only to the extent of informing them that advisors would render a "should" level opinion. There was no evidence that any partners other than one partner has ever read the advisor's opinion, only that the principals specifically discussed that the "should" level opinions would provide penalty protection. A second partner was unaware of what assumptions, if any, were made by the advisors. A third partner erroneously believed the taxpayer had a written opinion from the advisors at the time of the OTC transaction, apparently based on the first partner's informing him that the advisors had issued a "should" level opinion.
 4. There is a fourth reason the taxpayer has not qualified itself for the reasonable cause defense, namely, its apparent steps to conceal the tax losses from the sale of the subject stock on the tax returns to thereby potentially win the audit lottery and evade IRS detection.