

Tax Shelter ALERT

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■ PENALTY SUSPENSION EXTENDED A THIRD TIME

IRS Extends Bar Against Collecting Penalties from Small Businesses

The IRS has announced that it has extended for a third time, through March 31, 2010, the suspension of the collection of Code Sec. 6707A penalties from small businesses (and other small investors) for failing to disclose a listed transaction. Also, in response to a congressional request, the agency will immediately halt filing any tax liens solely for the purpose of protecting the future collection of those Code Sec. 6707A penalties covered by the suspension. Both relief measures are being undertaken to allow Congress more time to pass remedial legislation that would correct what Congressional leaders consider to be an unintended and unfair result.

Background

Under Code Sec. 6707A, as added by the American Jobs Creation Act of 2004 (P.L. 108-357), any taxpayer that fails to include information on a "reportable transaction" that is also a "listed transaction," is subject to a minimum, no-fault penalty of \$100,000 in the case of a natural person, and \$200,000 in any other case. According to lawmakers, more than 94 percent of the taxpayers that have been assessed were small businesses, despite the fact that Congress had originally aimed the penalty at "big corporation tax shelters." As early as May 2009, congressional representatives had requested that IRS Commissioner Douglas Shulman use the IRS's tax-administration authority to suspend collection efforts after discovering that Code Sec. 6707A penalties were disproportionately affecting small businesses. While these entities were unwitting participants in the tax shelters they had purchased, IRS penalty enforcement would cripple their ability to continue as a going concern, bankrupting them in many cases.

Suspensions

Commissioner Shulman responded to Congressional pleas in late Spring 2009 by placing a temporary hold on the IRS's collection efforts until legislation could be enacted. In July 2009 he announced that Code Sec. 6707A penalties would not be enforced through collections until October 1. Once September arrived, with no remedial legislation likely to pass at that time, Shulman extended the relief until December 31, 2009. Now, it's been extended through March 2010 on the continued assurances of congressional leaders that relief legislation is a "sure thing" and just needs to get on the calendar to pass.

The suspensions all covered taxpayers who had not disclosed listed transactions that generated a claimed tax benefits of less than \$100,000 (or \$200,000 for taxpayers other than individuals). The informal application of collection suspensions with respect to taxpayers that just miss the cutoff amounts has not been formally addressed by the IRS. Presumably, however, collection relief in those situations may come under the agency's general commitment during the current economic downturn to provide assistance on a case-by-case basis.

Proposed legislation

On November 16, 2009, Sen. Charles Grassley, R-Iowa, sponsored legislation, along with ranking members of the Senate Finance Committee and House Ways and Means Subcommittee, that would make Code Sec. 6707A penalties more proportional to the tax benefit actually claimed by the taxpayer. That legislation, the Small Business Penalty Relief Act of 2009, would impose a penalty equal to 75 percent of the tax benefit received, with a minimum of \$10,000 for corporations and \$5,000 individuals. However, relief in the form of paying only 75 percent of the tax benefits claimed caps out at the minimum penalty amount now automatically applied under 6707A: \$200,000 for corporations and \$100,000 for individuals. The legislation would also require the IRS to annually report to the Senate

Finance and Ways and Means Committees on the tax shelter penalties the agency had assessed during the year.

Comment: Although the press release accompanying the proposal complained that the penalty was being applied to "some small businesses that unknowingly invested in listed tax shelter transactions" and to "some businesses that [had] no ill intent," it appears that the proposed bill, as written, would give the IRS no rescission authority nor other deference to "intentions," continuing the no-fault approach when listed transactions are involved.

Lien removal

On December 22, 2009, Grassley sent a letter to Commissioner Shulman, urging him to remove all liens on small business resulting from Code Sec. 6707A assessments. Grassley reasoned that the temporary relief from penalty enforcement did not go far enough towards assisting small businesses that are now facing a tough credit market. He warned that placing tax liens on the assets of small businesses because of Code Sec. 6707A still placed their business operations in danger, even despite the fact that the IRS was not enforcing those liens. "Many small businesses use business assets or mortgage personal residences to secure lines of credit for the business. Imposing liens has significant negative implications for a small business that has limited access to capital," Grassley stated.

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Comment: Grassley did acknowledge some sort of exception for cases in which the IRS legitimately can show that a taxpayer would evade payment entirely.

In response, Commissioner Shulman replied in a December 23, 2009, letter that the IRS would extend the suspension of enforcement of Code Sec. 6707A against small businesses until March 1, 2010. Shulman also promised to deal with taxpayers experiencing financial difficulties because of liens already filed on a case-by-case basis. Shulman also assured Grassley that the agency would continue to defer issuance of tax liens based on Code Sec. 6707A. ❖

No Tax Court Jurisdiction Within Deficiency Proceeding

The Tax Court has held that it lacks jurisdiction in a deficiency proceeding to redetermine a taxpayer's liability for the Code Sec. 6707A penalty for failure to disclose a listed transaction (*Smith*, 133 TC No. 18, CCH Dec. 58,028, December 21, 2009). The court reasoned that, since the penalty would apply even if a taxpayer were to overpay a tax liability, the penalty was outside of the definition of a statutory deficiency and thus could not be addressed during a deficiency proceeding.

Married taxpayers brought this case before the Tax Court, claiming that it had jurisdiction over both their deficiency and the assessed Code Sec. 6707A penalties. The IRS argued that the court lacked jurisdiction in this instance because the Code Sec. 6707A penalty is an "assessable penalty" that must be paid upon notice and demand and assessed and collected in the same manner as taxes.

Court's analysis

The court acknowledged that Code Sec. 6707A did not have a specific provision exempting the penalty from a deficiency procedure. However, these penalties did not fall within the statutory definition of a deficiency, the court held. The court defined a statutory deficiency as the amount by which tax imposed under subtitle A or B or chapters 41 through 44 of the Internal Revenue Code exceeded the tax reported on the taxpayer's income tax return. Since Code Sec.

6707A penalties did not depend upon a deficiency, they could be assessed even where the taxpayer overpays their tax liability. The court clarified that the IRS may impose the Code Sec. 6707A penalty strictly for a failure to disclose a reportable transaction.

The court also pointed out that it has never exercised jurisdiction over an assessable penalty, such as that of Code Sec. 6707A, without some sort of relation to a statutory deficiency. It explained that, in this situation, the IRS issued a statutory notice of deficiency that did not determine the Code Sec. 6707A penalties. Assessment of these penalties was based upon subsequent determination that the taxpayers failed to disclose a listed transaction as required by Code Sec. 6011. Therefore, in this case, the IRS was entitled to assess and collect the penalty without a deficiency notice. ❖

IRS Uses Economic Substance to Win \$115 Million SILO Case

The Court of Federal Claims has denied a bank's claim for a refund of denied tax deductions related to its participation in sale-in, lease-out (SILO) tax shelter transactions (*Wells Fargo*, FedCl, January 8, 2010). The court determined that the transaction, which involved assets from domestic transit agencies and cellular telecommunications equipment, lacked economic substance and was invalid under the substance-over-form doctrine. It also found that the taxpayer's purported indebtedness was not genuine and did not allow for related interest deductions.

Comment: The court noted that the American Jobs Creation Act of 2004 (P.L. 108-357) amended the Internal Revenue Code to eliminate the purported tax benefits of sale-in, lease-out and lease-in, lease-out transactions. That did not imply, however, that transactions undertaken before 2004 were not just as vulnerable to a successful IRS attack. The IRS successfully attacked the transactions from which the taxpayer's 2002 deductions arose with both the substance-over-form and the economic-substance doctrines. The latest case also adds another reason to debunk the myth that the Court of Federal Claims was a more favorable venue than most for tax shelter

litigants, especially for those who participated in “the early years” when reputable law and accounting firms sold them.

The SILO transactions

Within its SILO transactions, the taxpayer bank leased the assets of the tax-exempt entities for a period longer than their remaining economic life, thus converting the lease into a sale for purposes of generally accepted accounting principles (specifically Financial Accounting Statement 13, *Accounting for Leases*). Then, the tax-exempt entities purportedly subleased the assets back from the taxpayer. As a result, the tax-exempt owned the capital assets, held legal title to those assets and was responsible for operating and maintaining them throughout the life of the transaction.

To facilitate the original lease, the taxpayer obtained a purported nonrecourse loan. Funds from this loan were used to make the taxpayer’s lease payments. However, since the tax-exempt entities used the same bank for purposes of this transaction, the supposed lease payments were actually received by an affiliate of the lender. The affiliate then made sublease payments on behalf of the tax-exempt entities to the taxpayer. The proceeds were then transferred back to the lender in satisfaction of the taxpayer’s loan-payment obligation.

As a result of this financial arrangement, the taxpayer claimed that it was entitled to claim ownership of the assets for tax purposes, since its lease of the assets at issue was converted to a sale under FAS 13. The taxpayer claimed large depreciation tax deductions under this position. It also claimed an interest deduction related to the interest expense incurred under the nonrecourse loan.

Substance over form

The court applied the substance-over-form doctrine to deny the tax benefits of the taxpayer’s SILO transactions. It held that, to claim the Code Secs. 167 and 168 deductions, the bank was required to prove it owned the equipment for tax purposes, even though those assets were physically used by various government transportation agencies during the tax years at issue. This ownership was required to have substance, not merely based on the bank’s intention to become

the owner or transactional documents labeling the bank as the owner.

Benefits and burdens. The taxpayer failed to prove ownership in substance because it failed to show that it acquired the “benefits and burdens” of owning the assets at issue. The taxpayer did not have any funds at risk with respect to the equipment, employing what the court referred to as a “100 percent loop debt,” where the purported borrower and the lender were affiliated parties and the entire loan proceeds were transferred back to the lender group at the closing of the transaction. Additionally, none of the borrowed funds were ever invested in the equipment or retained by either the taxpayer or the tax-exempt counterparties. Further, the financial arrangements under the SILO transaction prevented the tax-exempt entities from ever making any lease payment and the taxpayer from making any debt payment.

The taxpayer never assumed the risk that the assets at issue would decline in value. Through use of equity defeasance arrangements and strip-surety policies, the taxpayer would recover its initial investment and interest earned, even if the value of the assets declined during the SILO transaction. Further, the taxpayer could put a service contract in place to accomplish the same result.

Rights and duties of ownership. Also, the court ruled that the taxpayer was not owner in substance of the assets because no rights and duties of ownership of the assets transferred to the taxpayer at the closing of the SILO transaction. Title to, the right to exclusive possession, the right to use and the right to quiet enjoyment of the assets remained with the tax-exempt entities at the close the transactions. The tax-exempts also retained the duty to perform maintenance, duty to insure them and rights to profits and losses flowing from them. Nothing had changed in substance, except for the fact that the tax-exempts had surrendered tax deductions that they could not utilize.

No payments. The court also held the taxpayer not to be the owner in substance because there were no payments between the taxpayer and the tax-exempt counterparties during the transaction, only a circular flow of funds between the lender’s affiliated entities. While the leases at the center of the SILO transactions

provided for millions of dollars in payments, these funds were actually given to affiliates of the lender and invested in securities pledged to the taxpayer. The schedules for the rent payments under the leases and debt payments under the purported loan agreements offset each other so that no money changed hands after the transaction closed, except for the incentive payment paid by the taxpayer to the tax-exempt entities. At the heart of the SILO transactions, the taxpayer was merely paying the tax-exempt entities for their unused tax benefits.

Economic substance

The taxpayer was also not allowed its purported depreciation, interest or transaction cost deductions because the transactions lacked economic substance under both the objective and subjective prongs of the doctrine.

Objective prong. According to the court, the taxpayer did not have a reasonable possibility of making a profit from its SILO transactions sufficient to satisfy the objective prong of the economic-substance doctrine. The only source of nontax economic benefit to the taxpayer was the return of its investment, plus interest earned, which the taxpayer would have recognized without entering into the leases or involving the counterparties to this transaction.

Moreover, the net present value of the taxpayer's investment and return was less than its total cost of entering into the transaction. This was due to the significant transaction costs, incentive payments to the tax-exempt entities and cost of obtaining funds to enter into the transaction. As found in other SILO cases, a reasonable investor would have taken these costs into account when evaluating the reasonable possibility of making a profit.

Subjective prong. The court also found the taxpayer could not prove the subjective prong of economic substance because it had no nontax business purpose for entering into the SILO transactions. Without the claimed tax benefits or taxable revenue against which to offset the SILO tax deductions, the taxpayer would not have entered into the transactions. Further, once the IRS took notice of the taxpayer's SILO transactions, the taxpayer immediately stopped entering into them.

The key terms of the taxpayer's transactions, determined by tax considerations and the tax-

payer's need to eliminate risk, were the product of a software model rather than any negotiations or commercial realities, the court held. The court also noted artificially high appraisals of the fair-market value and suspiciously long remaining useful lives of the assets at issue within the transaction.

The taxpayer attempted to argue that it structured the transaction to comply with FAS 13 by frontloading income under the purported lease agreements of the equipment. This effort, the taxpayer argued, was a nontax business objective. However, the court disagreed, ruling that "the financial benefits of improper tax deductions cannot provide a non-tax business purpose for the transaction."

Interest deductions

Finally, the court found that the taxpayer was not entitled to Code Sec. 163(a) interest deductions because the underlying debt involved was from a nonrecourse debt loop and, thus, did not fall within the definition of qualified indebtedness. The lender provided funds that were used to make the purported rent payments, transferred to affiliates of the lender and then subsequently returned to the lender. While neither the taxpayer nor the tax-exempt entities ever had use of the funds, the lender retained use of the funds for almost the entire duration of the transaction. ❖

■ EFFECTIVE-DATE ARGUMENT UNSUCCESSFUL

SOL Extension Imposed on Son of BOSS Tax Shelter Liabilities

The Tax Court has applied the Code Sec. 6501(c)(10) statute of limitations extension for failure to disclose a listed transaction to investors in a Son of BOSS tax shelter transaction (*BLAK Investments*, 133 TC No. 19, CCH Dec. 58,039). Their partnership had failed to disclose the transaction as required by Reg. §1.6011-4. As a result, the general three-year statute of limitations for partnership items under Code Sec. 6229 was extended until one year after the earlier of the date the partnership or its material advisor reported the transaction. Additionally, the court held that, since the period for assessing the tax against the

partnership did not expire before October 22, 2004, the effective date of Code Sec. 6707A had no bearing on this decision.

Son of BOSS transaction

The partners in this case short sold U.S. Treasury notes and contributed the proceeds, along with the obligation to cover the short sale, to the partnership. True to the Son of BOSS form, they increased the basis of their partnership interests to account for the proceeds of the short sale, but not the obligation to cover it. They claimed that the obligation was not a liability for purposes of Code Sec. 752(b). The partnership subsequently redeemed their interests.

As a consequence, one of the partners reported no gain or loss on the redemption of his partnership interest. He claimed that, under Code Sec. 731(a), the partnership's payment did not exceed their partnership interest basis. Further, he argued that the basis of assets he received in the redemption was equal to their former basis in their partnership interest, less cash received, under Code Sec. 732(b). And, since the assets he received in the redemption were Swiss francs, he reported an over \$2.5 million ordinary tax loss upon converting the francs into U.S. dollars. The other partner claimed an over \$2.9 million short-term capital loss upon redemption of her partnership interest under Code Secs. 731(a)(2) and 741. Neither the partners nor their material advisor for the transaction reported their participation in the Son of BOSS transaction to the IRS Office of Tax Shelter Analysis.

In the IRS's notice of final partnership administrative adjustment (FPAA), it determined that the partnership was a sham, was formed and availed of solely for the purpose of overstating the partnership interest bases and lacked economic substance. However, for one of the tax years at issue (the 2001 tax year), the IRS issued the FPAA more than three years after the partnership filed its return.

Effective dates issue

Code Sec. 6501(c)(10) extends the three-year statute of limitations on tax assessments related to partnership items in cases where neither the taxpayers nor their material advisor reports a listed transaction. As enacted in the American Jobs Creation Act of 2004 (AJCA) (P.L. 108-357),

the Code Sec. 6501(c)(10) statute of limitations extension was applicable to deficiencies that did not expire before October 22, 2004. Code Sec. 6501(c)(10) incorporates, by cross-reference, the definition of a listed transaction given by Code Sec. 6707A. However, the partnership pointed out that the Code Sec. 6707A definition of a listed transaction was not effective for returns filed before October 22, 2004. As a result, the partnership asserted that Code Sec. 6501(c)(10) also could not apply to returns filed before that date.

Comment: The court surmised that the partnership was arguing there were two types of listed transactions: (1) Code Sec. 6707A listed transactions, and (2) listed transactions predating Code Sec. 6707A.

The court disagreed with the partnership, ruling that, despite its post-October 22, 2004, effective-date restriction, Code Sec. 6707A did not alter the definition of a listed transaction for purposes of Code Sec. 6501(c)(10). Code Sec. 6501(c)(10) potentially extended the statutes of limitations for all tax years open at the time of the passage of the AJCA. Applying the date restriction for Code Sec. 6707A to this rule would "render the express effective date of Code Sec. 6501(c)(10) meaningless, violating the cardinal principle of statutory construction," the court held.

The court also held that the Code Sec. 6707A date restriction should not limit the extended statute of limitations under Code Sec. 6501(c)(10) because the two provisions have different purposes as evidenced by expressed Congressional intent. The court ruled that, if Congress had intended the Code Sec. 6707A date restriction to apply to Code Sec. 6501(c)(10), it would have expressly done so.

Definition of listed transaction

The Code Sec. 6501(c)(10) extended statute of limitations only applies to taxpayers who fail to disclose a listed transaction. The court held that the partnership's transaction was substantially similar to the Son of BOSS transaction described by the IRS in Notice 2000-44. Although it did not involve the purchase and writing of options, it involved short sales of securities. And, according to the court, "the fundamental components of the transaction ... are the generation of funds through the creation of a liability and contribution of the funds ... and the associated liability

to the partnership without adjusting the partner's basis for the liability." Here, the partners had generated funds through the short sale of Treasury notes and contributed the funds and their accompanying short-sale obligation to the partnership. However, they did not reduce their partnership interest bases by the obligation. They disposed of the partnership interests and claimed more than \$5 million in tax losses.

Partnership versus partner item

Concurring and dissenting opinions, also provided with the majority decision, debated whether the court had jurisdiction to review the statute-of-limitations extension issue. Given that the proceeding was a partnership-level proceeding under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (P.L. 97-248) rules, the court could only review partnership items. However, dissenters asserted that the statute of limitations extension issue was an affirmative defense to be individually asserted by each partner in their own proceeding.

The concurring judges asserted that Code Sec. 6226(d)(1) allows partners to intercede into a partnership-level hearing in order to argue that the statute-of-limitations period for assessing the tax has expired with respect to their interest. Alternatively, the concurring judges pointed to the fact that whether the partnership's transaction was a listed transaction within the meaning of Code Sec. 6501(c)(10) was a partnership item. Since it was the duty of the partnership to disclose the transaction, the statute-of-limitations extension resulting from failure to fulfill that duty, therefore, was also a partnership-level item.

The dissenting judges, however, argued that the court did not have authority in a partnership-level hearing to decide the statute-of-limitations extension issue, as it was a computational adjustment to the partners' tax years. The judges asserted that the statute-of-limitations defense was an affirmative defense, personal to each partner, that could only be asserted at a subsequent partner-level proceeding.

The dissenting judges also applied a narrow interpretation to Code Sec. 6226(d)(1), asserting that it only granted the court jurisdiction to decide a partner's claim that it had no interest in the outcome of a partnership-level proceeding. As a result, partners who conceded that they had

an interest in the outcome of the partnership-level proceeding, the dissenting judges argued, could not bring an action during that proceeding with regard to the statute of limitations. ❖

■ TAX COURT JURISDICTION LIMITED

D.C. Circuit Upholds Tax Court Jurisdiction over Partnership's Sham Status

The U.S. Court of Appeals for District of Columbia Circuit recently affirmed the Tax Court's ruling that it had jurisdiction to determine whether a suspected Son of BOSS tax shelter partnership was an economic sham and should be disregarded for federal income tax purposes (*Petaluma FX Partners LLC*, CA-DC, January 13, 2010). However, the court disagreed with the Tax Court's assertion of jurisdiction over whether the partners had no outside basis in the partnership and assessment of accuracy-related and valuation-misstatement penalties.

Son of BOSS tax shelter

The investors at issue entered into a Son of BOSS tax shelter, forming a partnership, engaging in foreign currency option trading and contributing offsetting long and short foreign currency options to the entity. The investors increased their partnership interest bases to reflect the long options, but did not reduce those bases to account for their short-option obligations. The partnership made liquidating distributions to the investors of cash and shares of corporate stock. The investors sold their stock, reported an inflated-basis for tax purposes and claimed over \$25 million in short-term capital losses.

The IRS issued a notice of final notice of partnership administrative adjustment (FPAA) to the partnership for the tax year at issue, disallowing all partnership items on the partnership return and reducing them to zero. It also reduced the partners' outside partnership bases to zero, even though these were not listed on the partnership's original return. Additionally, attached to the FPAA was an exhibit determining that the partnership was formed solely for tax avoidance, was a sham and lacked economic substance. The exhibit also assessed accuracy-related penalties under Code Sec. 6662(a).

Lower court decision

In the Tax Court proceeding, the partnership conceded the IRS's reduction of the partnership items to zero. However, it argued that the Tax Court lacked jurisdiction over the other issues described in the FPAA and its accompanying documents. The Tax Court awarded summary judgment to the IRS, finding that, under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (P.L. 97-248), it had jurisdiction over partnership items. During a partnership-level proceeding, the Tax Court held, this included whether the partnership was a sham, lacked economic substance or should be otherwise disregarded for federal income tax purposes. Because "there can be no adjusted basis in a disregarded partnership," the court held that it had jurisdiction during the partnership proceeding to determine whether the partners' outside bases should have been reduced to zero. For similar reasons, the Tax Court also asserted jurisdiction over the accuracy-related and gross-valuation misstatement penalties assessed by the IRS.

Disregarding the partnership

The Court of Appeals agreed with the Tax Court's finding that it had jurisdiction to determine whether the partnership was a sham and lacked economic purpose because these were partnership items under the TEFRA procedures. Under Code Sec. 6233 and Reg. §301.6233-1T(a), the court had jurisdiction to determine whether an entity is a partnership for the tax year. Additionally, the sham determination met the definition of a partnership item under Code Sec. 6231(a)(3). Application of the income tax provisions of Subtitle A to the tax liability of a taxpayer receiving income from a purported partnership entailed determination of the validity of the partnership.

Also, the determination of whether a partnership is a sham and lacks economic substance is a partnership item, the court held, because it is a legal determination that underlies the amount and characterization of other partnership items. Further, it was logical to determine whether a partnership was a sham at the partnership level because it could not be a sham with regard to one partner, but valid with respect to another.

Outside basis

However, the Court of Appeals agreed with the partnership and ruled that the Tax Court did

not have jurisdiction to determine whether its partners had no outside bases in the disregarded partnership. The Court of Appeals ruled that basis in the partners' partnership interests was an affected item, not a partnership item. These were to be determined at the individual partner level, where the IRS could make computational adjustments to each partner's tax liability.

Penalties

Finally, the court also agreed with the partnership's argument that, since the Tax Court lacked jurisdiction to review determine each partner's outside basis, then it also lacked jurisdiction to consider whether the assessed accuracy-related penalties also applied. The court held that the Tax Court's jurisdiction over whether the partnership should be disregarded for federal income tax purposes did not give it jurisdiction to also consider the accuracy-related penalties. ♦

AICPA Critiques Proposed Regs on Tax Shelter Items

The American Institute of Certified Public Accountants (AICPA) has submitted comments on proposed regulations under Code Sec. 6231 that seek to alter the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (P.L. 97-248) proceedings for suspected tax shelters. The AICPA expressed to the IRS Office of Chief Counsel that the regs, in their current form, could potentially violate taxpayers' right to due process with respect to administration of tax laws.

Background

In February 2009, the Treasury and the IRS issued proposed regs (NPRM REG-138326-07) under Code Sec. 6231 allowing the IRS to convert partnership items associated with a listed transaction within the meaning of Reg. §1.6011-4(b)(2) to nonpartnership items for purposes of TEFRA. As a result, the IRS could directly prosecute liabilities resulting from abusive tax shelters against the partners themselves. The agency would be able to skip the step of first bringing a case against the partnership before pursuing a partner-level proceeding pertaining to the tax-shelter-related items.

Potential due process issues

The AICPA asserts the proposed regs have the potential to violate taxpayers' due process rights in cases where a transaction becomes listed after the taxpayer's participation and report on its tax consequences. In these cases, the AICPA pointed out, the regs retroactively apply on the date the IRS sends notice that it is changing the suspected tax shelter item to a nonpartnership item. The taxpayer could be unaware at the time of entering into the transaction that it could be removed from the traditional TEFRA procedures. The AICPA continued that such a rule could place "undue burden" on taxpayers to be on the lookout for future rulings and laws that could alter treatment of transactions the IRS currently deems to have a legitimate business purposes. It also reported that tax-avoidance-related penalties, such as the failure-to-disclose penalties, would be "harsh and highly unwarranted" in this situation.

Administrative efficiency

In the preamble to the proposed regs, the IRS reported that suspected tax shelter schemes were evolving into multiple layers of ownership that often provided benefits to a single or small group of investors. As a result, the agency was looking for more efficiency in its prosecution of these cases. The AICPA asserted in its comments, however, that the IRS failed to adequately demonstrate how examining partners individually, rather than at the partnership level, would reduce the agency's administrative burden. The AICPA pointed out that, even if the IRS were to directly prosecute the investors at the core of the shelter, examiners would still have to wade through the various layers of entities used to facilitate the shelter in order to ultimately assess any resulting liability. Further, the AICPA argued that, where multiple investors were involved, prosecuting tax shelter items in the traditional partnership-level hearing under TEFRA would continue to be more efficient than pursuing multiple partner-level proceedings regarding the same items.

Substantially similar transactions

The AICPA also pointed out criticism concerning possible overbreadth in the application of Reg. §1.6011-4(c)(4) in its reach of transactions

substantially similar to listed transactions. Some practitioners have claimed that the rule is so broad that even the product of nonabusive, routine tax planning may fall within the IRS's purview of a listed transaction. Similarly with this adjustment of the TEFRA rules, the AICPA argued, the IRS may adjust the partnership items for certain transactions which may not be abusive.

Tax matters partner notification

The proposed regs would require the IRS to only mail one notice indicating a partner's suspected tax shelter item has been converted to a nonpartnership item. This is different from the current system, where tax matters partners are notified of all tax adjustments related to both the general partnership and the specific partners' interests. The AICPA asserts that the tax matters partner should also receive a notice if a partner's suspected tax shelter items are converted.

GOVERNMENT FILES APPEAL IN CASTLE HARBOUR II

The government has filed its appeal of a federal court's decision in favor of a taxpayer in the *Castle Harbour II* tax shelter case. In that case (*TIFD III-E*, DC-Conn., 2004-2 USTC ¶150,401, 342 FSupp 2d 94), a U.S. taxpayer established a partnership with two foreign banks as partners to raise additional capital for his business. However, the partnership interests of the banks were self-liquidating, meaning that partnership income was used to buy out their interests over time and, thereby, regularly increase the taxpayer's ownership percentage of the entity.

After the taxpayer won during a bench trial, the U.S. Court of Appeals for the Second Circuit denied the taxpayer's treatment of the foreign banks as partners, holding that their interest was similar to a secured loan. It remanded the case back to the district court level. However, in October 2009, the federal district court again ruled in favor of the taxpayer's treatment of the banks as partners for federal income tax purposes.

On remand, the federal district court held the foreign banks were entitled to treatment as partners in a Code Sec. 704(e)(1) family partnership because they owned an interest in the entity, had capital interest in the entity, and their contributed capital was a material factor in the entity's production of income. The court was not persuaded by the IRS's argument that the partnership was a sham or that it lacked economic substance. It was also not convinced by the government's argument that the allocations of income to the banks lacked substantial economic effect.

The AICPA argued that tax matters partners are the most knowledgeable about the transactions at issue. Additionally, contacting them would allow taxpayers the “economies of a common defense.” Further, the AICPA distinguished the conversion of suspected tax shelter item from situations in which the IRS suspends a tax matters partner’s special rights.

Dual-proceedings potential

The AICPA pointed out that conversion of a suspected tax shelter item to a nonpartnership item does not negate the application of the traditional TEFRA procedures to the partner’s other items. As a result, partners may be subject to two proceedings regarding their partnership interest at the partner level: one under TEFRA and another only for the listed transaction item. The AICPA estimated that many questions surrounding statutes of limitations, basis and at risk analysis would all arise due to these “dual proceedings.”

Suggestions

To ameliorate some of the problems discussed above, the AICPA suggested that the IRS limit application of the final regs to transactions identified as listed on or before the date the taxpayer participates in the transaction. It also suggested that the IRS notify tax matters partners of the conversion of suspected tax shelter items and give more specific definitions concerning tax avoidance and concerning what transactions are substantially similar to a listed transaction. ❖

■ AMCORP INVESTORS’ REFUND CLAIMS DENIED

Shelter Investors Fail to Leverage Settlement into Refund Claims

The U.S. Court of Appeals for the Federal Circuit recently ruled that taxpayers who invested in AMCORP partnership tax shelters during the 1980s did not have standing to challenge the IRS’s denial of their claims for tax refunds related to the wind-down of those vehicles (*Schell*, Fed. Cir., 2010-1 USTC ¶150,134). This was because the taxpayers’ subsequent refund claims and the issue of whether their transaction was a sham transaction were partnership items. Further,

even though the taxpayers entered into a settlement agreement with the IRS, this agreement did not transform the issue of whether their partnerships were engaged in sham transactions into a partner-level item.

Background

The taxpayers invested in several limited partnerships owned by American Agri-Corp, Inc. (AMCORP) during the 1980s. The partnerships reported losses from farming expenses of approximately \$18.5 million, with the taxpayers reporting over \$360,840 in tax losses from their *pro rata* share of the partnerships’ losses. The IRS issued a notice of final partnership administrative adjustment (FPAA) to the partnerships denying their claimed losses. The IRS determined that their activities constituted a series of sham transactions and lacked economic substance.

Subsequently, the taxpayers entered into settlement agreements with the IRS, reducing their reported losses by 53 percent. However, the agreements did not address the IRS’s determination in the FPAA that the partnership activities were sham transactions.

The taxpayers filed refund claims for several subsequent tax years related to the settlement and corrections of their erroneous reporting of the partnerships’ termination. The taxpayers claimed that the losses were attributable to a decrease in the tax basis for their partnership interests upon termination of the partnerships.

Court’s analysis

The Court of Appeals agreed with the trial court’s ruling and held the taxpayers had no standing to pursue their refund claims under Code Sec. 7422(h). The court agreed with the government’s argument that basis in the taxpayers’ partnership interests were items “attributable to partnership items,” and therefore, no civil action for refund could be brought with respect to these items.

The taxpayer’s refund claims were based upon whether the partnership transactions were shams. The question of whether a partnership transaction is a sham, according to precedent, is a partnership item, the court explained. As a logical consequence, the court concluded that the taxpayers’ refund claims were attributable to partnership items and thus barred by Code Sec. 7422(h).

The taxpayers attempted to argue under Code Sec. 6231(b)(1)(C) that, since they had entered into a settlement agreement with the IRS, their disputed tax items became nonpartnership items that they could litigate at a partner-level proceeding. Alternatively, they argued that, since the IRS failed to address the issue of whether their tax shelters were sham transactions in the settlement agreement, this absence of determination also converted the issue to a nonpartnership item. The court was not convinced by these arguments. Instead it found that not all settlement agreements are required to be comprehensive under Reg. §301.6224-3T(b). Additionally, it ruled that, although the IRS did not settle the issue of whether the partnership transactions were shams, the agency had not conceded that they were not shams. ❖

■ SETTLEMENT INITIATIVE EVIDENCE EXCLUDED

Son of BOSS Investors Fail to Turn Review into Belated Attack on Deficiency

The Tax Court recently granted an IRS motion *in limine* to exclude a taxpayer couple from presenting evidence of the IRS's Son of BOSS settlement initiative in dispute of the Code Sec. 6662(h) underpayment of tax penalty stemming from their investment in a Son of BOSS tax shelter (*Olesen*, T.C. Memo. 2009-307, CCH Dec. 58,045(M)). The court held that because the taxpayers had received a deficiency notice indicating a tax assessment and the proceeding was in review of the IRS's collection process, they were precluded from producing evidence that challenged their underlying tax liability.

Liability ignored

The taxpayers invested in a Son of BOSS tax shelter transaction. The IRS announced its intention to enter into special settlement agreements with Son of BOSS participants in 2004. Yet, the taxpayers failed to file an election to participate or timely provide the IRS with sufficient information concerning their investment in the transaction.

The IRS subsequently issued a notice of deficiency to the taxpayers, determining that their investment vehicle lacked economic substance

and disallowing all related tax items that the couple claimed. The notice also determined that they were liable for the Code Sec. 6662(h) penalty. The taxpayers did not file a petition with the Tax Court to contest these determinations, and the IRS issued a deficiency notice to the couple assessing a resulting tax deficiency and penalty.

After the taxpayers failed to pay the assessments, the IRS issued two notices of federal tax liens to them. To review the IRS's collection action, the taxpayers sought a collection due process hearing with the IRS Office of Appeals. The Appeals officer determined that they were precluded from challenging their tax liability resulting from the Son of BOSS tax shelter because they had received the deficiency notice.

The taxpayers finally brought suit in the Tax Court to challenge the IRS's collection actions. However, in this action to review the agency's collection actions, the taxpayers sought to introduce evidence of the IRS's Son of BOSS settlement initiative in order to challenge assessment of their underpayment penalty. The IRS countered with a motion to dismiss this evidence, asserting that the taxpayers received a deficiency notice and, therefore, could not present evidence challenging the liability underlying their assessed penalty. The taxpayers argued that they never received the deficiency notice.

Court's analysis

The court ruled that it had jurisdiction in this collection-review proceeding as a review of the IRS Office of Appeals determination. Under Code Sec. 6330(c)(2)(B), taxpayers are prohibited from challenging the existence or amount of any underlying tax liability before the IRS Office of Appeals if they have already received a statutory notice of deficiency from the IRS or otherwise had the opportunity to dispute their liability.

The court held that the IRS had presented sufficient evidence to show that the taxpayers actually received the deficiency notice. The taxpayer failed to present evidence to rebut this presumption. Thus, since it went to the existence and amount of the taxpayers' underlying Son of BOSS tax liability, the taxpayers could not present evidence pertaining to the IRS's settlement initiative for Son of BOSS cases to dispute their penalties. The court upheld the IRS's motion *in limine*. ❖

Promoter Penalties Correctly Assessed in Pay-Phone Shelter

A federal district court recently granted the IRS a motion for summary judgment in a case where a taxpayer sold interests in his pay-phone business, promising tax benefits to investors (*Tummino*, DC-Ore., 2010-1 USTC ¶150,135). No genuine issue of material fact existed concerning the taxpayer's liability for promotion of an abusive tax shelter or collectibility of that liability.

Pay-phone program

The taxpayer developed a business that sold pay telephones to individuals, who would then contract with a phone company to manage those phones.

During the years at issue, he developed, promoted and sold investments in the program. The taxpayer created advertising materials that stressed investment could reduce investors' federal income tax liability. The materials led investors to believe that purchase of a pay phone was the equivalent of purchasing a small business and entitled them to claim Code Sec. 179 depreciation deductions and the Code Sec. 44 disabled-access tax credit.

Tax shelter promotion penalties

After the U.S. Securities and Exchange Commission obtained an injunction against the taxpayer's sale of the pay phones, the IRS assessed over \$1.4 million in tax shelter promoter penalties against the taxpayer under Code Sec. 6700. It applied a federal tax lien against his real property. However, the taxpayer liquidated his IRA retirement accounts by withdrawing their entire balances.

The IRS rejected his subsequent settlement offer as a result.

Liability

The court ruled that the IRS properly assessed the tax shelter promoter penalties against the taxpayer. To establish that the taxpayer participated in the promotion of a tax shelter under Code Sec. 6700(a), the IRS was required to prove he: (1) participated in the sale of an investment plan, and (2) made statements with respect to tax benefits which he knew were false or fraudulent. The first prong had

been established, the court ruled, by the fact that the taxpayer admitted to developing a sales force and to marketing the pay-phone program.

The court also found that the IRS had proven the second prong of the tax-shelter-promotion test. The taxpayer had made statements with respect to tax benefits through his marketing and training materials given to sales agents and customers. He had reason to know these statements were false, the court found, because he was a "sophisticated business person" and was aware of the importance of consulting with expert advisors who had experience in the sale of securities and insurance. And, finally, the misstatements he made in promotion of the pay-phone investment program were material. "No evidence allows a reasonable inference other than that the tax credit is what interested customers in the pay phone program and that ... they would have been less likely to invest in the pay phones had they known of the IRS's treatment of the deductions and tax credits promised," the court ruled.

Collectibility

The court also found that the taxpayer had failed to raise a genuine issue of material fact as to whether the IRS abused its discretion by determining that the tax-shelter-promoter penalties were collectible. While the taxpayer argued that the penalties were not collectible based solely on his other assets, the IRS had concluded that his IRA retirement accounts were "dissipated assets" that should have also been included in his settlement offer.

According to the court, the Internal Revenue Manual (IRM) does not include dissipated assets used by a taxpayer for necessary living expenses into the IRS's calculation of reasonable collection potential. However, a taxpayer's offer in compromise should be rejected, under the IRM, where the taxpayer fails to provide enough information to allow the IRS to adequately determine how much of the dissipated assets should correctly be included in the reasonable collection potential calculation. According to these rules, the IRS correctly denied the taxpayer's settlement offer, the court concluded. The taxpayer failed to rebut the argument that his withdrawals from the IRA retirement accounts were dissipated assets. Thus, he failed to raise a genuine issue of material fact as to whether the IRS abused its discretion. ❖