

Tax Shelter ALERT

Vol. V, No. 5, May 2008

INSIDE

- ▼ IRS Scores Another Victory in Crackdown on LILO Tax Shelter..... 3
- ▼ Built on Common Transactions, Could Affect Legitimate Taxpayers..... 4
- ▼ IRS Loses ‘Son of BOSS’ Shelter Case on Multiple Arguments..... 5
- ▼ Bond Short Sale Obligation Required to Reduce Partnership Basis..... 6
- ▼ IRS Not Deterred by ‘Bump in the Road’ for Son of BOSS Litigation 7
- ▼ ‘Son of BOSS’ Investors Split Summary Judgment Holdings with IRS..... 8
- ▼ IRS Pursuing Tax Shelter Hold-Outs, Commissioner Warns.. 9
- ▼ LMSB Trains Examiners on Application of Code Sec. 6694 Penalties 11
- ▼ IRS Continues Winning Streak with Sale-In, Lease-Out Transaction Decision..... 12

■ IRS HANDED ANOTHER LOSS

Federal Court Adopts *Textron’s* ‘Because of Litigation’ Test for Work Product Privilege

Another federal court recently threw IRS a curveball when it held that it would accept the more lenient “because of litigation” test in determining whether a taxpayer has prepared its tax accrual workpapers in anticipation of litigation sufficient to successfully invoke the work product privilege (*Regions Financial Corp.*, DC-Ala., May 12, 2008). The court’s recent opinion found that, not only had the taxpayer at issue met both tests when it requested opinions from its attorneys and accountants regarding its risky transactions, but it also did not waive privilege when it disclosed the workpapers to an independent auditor.

Comment: Robin Greenhouse, partner at the law firm of **McDermott Will & Emery** in Washington, D.C., pointed out to CCH that, while application of the work product doctrine in *Textron* and *Regions* was the same, the facts were slightly different in what the IRS was seeking from the taxpayer. She stated, “in *Textron*, they were looking more at the actual tax accrual workpapers themselves...the items indicating the percentage of likelihood of success, whereas *Regions Financial* considers the tax opinions that form the basis for the determinations made in the tax accrual workpapers.” She also advised that the courts in *Textron* and *Regions Financial* were concerned that IRS would obtain an unfair advantage if the tax opinions, which contain an analysis of the taxpayer’s strengths and weaknesses, were produced to the IRS.

Comment: Charles Rettig, of **Hochman, Salkin, Rettig, Toscher & Perez, P.C.**, Beverly Hills, Calif., told CCH that “the court carefully differentiated the ability of the government to learn the facts regarding the underlying transaction as compared to the ability of the government to learn the ‘mental impressions and opinions’ of the *Regions’* lawyers.” He also advised practitioners to “carefully review *Regions* and *Textron* for an analysis of the differences between the attorney-client privilege, the statutory Code Sec. 7525 privilege for ‘tax advice’ available to ‘federally authorized tax practitioners,’ and the ‘work-product privilege.’”

CCH Comment: The court not only paid deference to the recent *Textron* decision applying the lesser standard, it went beyond that decision to show that either standard could have proven this taxpayer to have prepared its tax accrual workpapers in anticipation of

litigation. IRS Chief Counsel Donald Korb has noted that the IRS will continue to act with self-imposed restraint in limiting use of its summons power, but that it is undeterred by an occasional setback from asserting its right to do so. The next big showdown is set for late fall, when the First Circuit is expected to hand down its *Textron* decision, on appeal by the government.

IRS summons

During the tax years at issue, the taxpayer engaged in two listed transactions. The IRS served a summons upon the taxpayer's outside independent auditor, seeking its tax accrual workpapers relevant to the transaction. The taxpayer instructed the auditor to withhold the documents and subsequently filed a motion to quash the agency's summons in federal court. The dispute between the government and the taxpayer involved whether the workpapers were prepared in anticipation of litigation to qualify for the work product privilege and, even if so, whether the privilege had been waived by the taxpayer's disclosure of the workpapers to its independent auditor.

'In anticipation of' test

To receive protection from IRS summonses under the work product privilege, Rule 26(b)(3) of the Federal Rules of Procedure requires a taxpayer to prepare its tax accrual workpapers

"in anticipation of litigation." The court noted that two major tests have been put forth by Courts of Appeals in determining whether a taxpayer has prepared its tax accrual workpapers in anticipation of litigation. The Fifth Circuit requires the "primary motivating purpose" of the workpapers to be the threat of litigation, while the Second Circuit looks to whether the document is more broadly prepared or obtained with the possibility of litigation in mind. The district court in the most recent case stated, "If it were forced to decide the question, the court concludes that the Eleventh Circuit would align itself with the majority of the other courts of appeal and adopt the 'because of litigation' test."

'In anticipation of' litigation determination

The court found that the taxpayer proved it created the documents in anticipation of litigation under both the "because of litigation test" and "primary motivating purpose test." The government had argued that the taxpayer only created the workpapers in order to create a tax reserve that accurately reflected its contingent liabilities, a result needed for an unqualified audit opinion. The court did not find any evidence to support this position. To the contrary, it reasoned that the taxpayer would not have obtained opinions "were it not for anticipated litigation" with the taxing authorities.

EDITORIAL ADVISORY BOARD

Arthur L. Berkowitz, CPA

Owner
Arthur L. Berkowitz CPA
Aliso Viejo, Calif.

Tom Durham

Partner
Mayer, Brown, Rowe & Maw LLP
Chicago

Mark H. Ely

National Partner in Charge
IRS Practice, Procedure and
Administration
KPMG
Washington

Lawrence M. Hill

Partner
Dewey Ballantine LLP
New York

Jeffrey H. Paravano

Firmwide Chair of Tax,
Personal Planning and
Employee Benefits
Baker & Hostetler LLP
Washington

Tax Shelter Alert (ISSN 1559-9906) is published monthly by CCH, a Wolters Kluwer business. Subscription inquiries should be directed to *Tax Shelter Alert*, 4025 W. Peterson, Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. E-mail: cust_serv@cch.com. ©2008 CCH. All Rights Reserved. *Tax Shelter Alert* also is available electronically on the Internet with a

searchable back-issue archive. Call customer service at (800) 449-8114 to get a trial electronic subscription. Photocopying or reproducing in any form in whole or in part is a violation of federal copyright law and is strictly prohibited without the publisher's consent. *Tax Shelter Alert* is designed to provide general information on business taxes and not to offer legal or accounting advice on individual problems. Questions on specific issues should be addressed to the professional of your choice. No claim is made to original government works; however, within this product or publication, the following are subject to CCH's copyright: (1) the gathering, compilation, and arrangement of such government materials; (2) the magnetic translation and digital conversion of data, if applicable; (3) the historical, statutory and other notes and references; and (4) the commentary and other materials.

Kurt Diefenbach, Managing Editor
Riverwoods, Ill.

kurt.diefenbach@wolterskluwer.com

George Jones, Managing Editor
Washington, D.C.

george.jones@wolterskluwer.com

Elice Webster, Executive Editor

Jim F. Walschlager, Coordinating

Editor, Riverwoods, Ill.

jim.walschlager@wolterskluwer.com

**TO
SUBSCRIBE:**
Please call
(800) 449-8114

It also ruled that the taxpayer was motivated primarily by the prospect of litigation. It stated that, while litigation was not certain at the time it consulted the experts, certainty was not a requirement under the primary motivating purpose test. Additionally, while the workpapers may have some use outside of litigation, the taxpayer was not required to have preparation for litigation as its sole reason for creation in order for the privilege to apply.

No privilege waiver

Finally, the court decided that the taxpayer had not waived the work product privilege by providing a copy of its tax accrual workpapers to an outside independent auditor. The court held that the auditor was neither an actual nor a conduit to a potential adversary of the taxpayer. The court also pointed out that a confidentiality agreement protected the taxpayer's disclosures to the auditor from further disclosure ❖

IRS Scores Another Victory in Crackdown on LILO Tax Shelter

Applying the substance-over-form doctrine, the Court of Appeals for the Fourth Circuit has handed the IRS another victory on the lease-in, lease-out (LILO) front of its ongoing tax shelter crackdown (*BB&T Corporation*, CA-4, May 1, 2008; 2008-1 USTC ¶150,306). Upholding the trial court, the Fourth Circuit denied the taxpayer rental payment deductions under Code Sec. 162 and Code Sec. 163 interest payment deductions, increasing its taxable income by over \$9 million. Due to what the court found to be the circular nature of the transaction, the taxpayer did not acquire in substance a genuine leasehold interest or genuine indebtedness.

Comment: "Taxpayers have once again been told by a federal court that the government may look at the substance, rather than the form, of a transaction to determine its legitimacy for tax purposes," Assistant Attorney General of the Justice Department's Tax Division Nathan Hochman, said in a statement. IRS Commissioner Douglas Shulman also weighed-in saying, "The IRS has fought hard to stop abusive tax shelters that twist and distort tax law to

generate unwarranted deductions. Now is the time for taxpayers involved in LILOs to put these transactions behind them."

CCH Comment: It is not a stretch to assume that the IRS was quick to publicize this victory to offset perceptions that it is "on the run" after its surprise defeat in *C.E. Sala*, DC-Colo., 2008-1 USTC ¶150,308, April 22, 2008. *Sala* involved a Son of BOSS transaction. These transactions often vary in their degree of aggressiveness, giving some investors a chance at a winning argument. This case involved a LILO arrangement, which, as one of the earlier shelter products, was more cookie-cutter in approach and usually more blatantly abusive.

Background

The taxpayer corporation leased a 22-percent interest in pulp manufacturing equipment from a foreign company indifferent to U.S. income tax. The foreign company simultaneously signed a shorter-term sub-lease for that very same equipment back from the taxpayer, with the option to renew.

To eliminate the risk of economic loss from the transaction, while ensuring that it still qualified as a genuine lease, the taxpayer obtained a nonrecourse loan from a bank. Funds from this loan were used by several trusts to meet both the taxpayer's obligations and the foreign company's obligations under the transaction. The result was a circular intrabank transfer of funds.

CCH Comment: The court noted that Reg. §§1.467-1 through -5 weakened the ability of taxpayers to perform successful LILO transactions. This particular transaction, however, occurred between the time the Code Sec. 467 regs were issued and when they were effective.

The IRS denied the taxpayer's claimed deductions for rental payments, interest on the nonrecourse loan and amortization of the transaction fees. The district court upheld these denials, finding the taxpayer had not acquired a genuine leasehold interest in the equipment, all of the obligations involved were offsetting, and that the taxpayer's nonrecourse loan did not constitute genuine indebtedness.

Appellate analysis

The Fourth Circuit applied the substance-over-form doctrine. The court found that the taxpayer

lacked a genuine leasehold interest in the equipment and was, therefore, not entitled to deduct the rent payments under Code Sec. 162(a)(3).

Although the taxpayer received certain rights and obligations in the transaction, the circular nature of the transaction allowed it to return them back to the foreign company. Further, while the form of the transaction showed millions of dollars in rent deemed to have been exchanged by the parties, the substance indicated that the only funds that truly exchanged hands constituted a \$6 million incentive payment given to the foreign company. ❖

■ INTERMEDIARY TRANSACTION TAX SHELTERS
WORRY SOME

Built on Common Transactions, Could Affect Legitimate Taxpayers

While the intermediary abusive tax shelter may not be a marketed scheme, recent IRS regulations and court rulings on the subject may be traps for the unwitting practitioner. Marc Countryman, an attorney-advisor for the Treasury, and Stephen Fattman, special counsel to the IRS Associate Chief Counsel (Corporate), discussed current developments regarding this transaction during a May 10 breakout session of the American Bar Association Section of Taxation 2008 May Meeting in Washington, D.C.

Intermediary tax shelters are listed transactions under Notice 2001-16, 2001-1 CB 730. The panel discussed the recent *Enbridge Energy Company, Inc.* decision (2008-1 USTC ¶150,266), in which the court determined that a transaction involving the sale of stock and assets between two corporations through a shell corporation was an abusive intermediary tax shelter within the meaning of Notice 2001-16. It also discussed the Treasury's recent publication of Notice 2008-20, I.R.B. 2008-6, 406, which modified Notice 2001-16 with respect to the types of people considered to be participants in tax shelters and introduced four components the IRS and Treasury consider to be at the core of an intermediary tax shelter. Countryman and Fattman expressed their support for the decision and advocated for their views in the published guidance.

Enbridge

The goal of the court-determined abusive tax shelter in the *Enbridge* decision was to use an intermediary shell corporation to create a stock sale of the target company, while creating an asset sale of the target corporation's assets. This would allow the purchaser corporation to receive a cost basis in those assets, where it would have otherwise received a carryover basis in them under a regular stock purchase of the target.

At least one practitioner questioned the court's decision in *Enbridge* to recharacterize the transaction as a stock sale instead of a sale of the target corporation's assets. In response to this query, Fattman replied, "The Service has and will continue to pursue adjustments on the seller side." Yet, he also added, "It's a facts-and-circumstances determination. You may be influenced by which side brings in the intermediaries."

Notice 2008-20

Practitioners also asked Countryman and Fattman about the IRS's determinations in Notice 2008-20. The Service concluded that one of the factors of an intermediary tax shelter includes situations where "all or most" of the target corporation's assets are sold in a gain transaction within the 12-month period before, or 12-month period after, 50 percent of the target corporation's stock was sold. Some practitioners were confused as to the meaning of "all or most" of the target's assets.

Fattman declared, "I think that, if you're at 50 percent or less, then you're probably okay." Also in support, Countryman explained that this was the Treasury's method of creating leeway within the guidance for legitimate business deals, while refraining from a bright-line rule that could potentially label them as tax shelters. "There are the intermediary transactions you're trying to catch, but at the same time, you're trying to balance and not catch the real business deals," Countryman noted. "It's very difficult to strike that balance.... The main message here is that we understand that this is difficult to deal with, and we are very much open to hear your comments on how the factors may be improved to achieve what we're trying to do."

To ensure they do not unwittingly fall within the application of the intermediary tax shelter

doctrine, Fattman recommended that corporations engaging in stock purchases make sure they perform adequate due diligence before the sale. He also recommended drafting a covenant within the purchase agreement requiring the purchaser corporation to recognize gain on the sale of any assets within the 12-month period after the stock purchase, or restricting the sale of the assets within the period. However, he warned that even these protective measures may not be absolute.

"I think you have to understand where the government has been and where it is coming from," Fattman stated. He continued, "The first notice, unlike a lot of other transaction notices, did not shut down this shelter. You look at buyers' and sellers' returns who are doing legitimate deals and, except for the party entities, real parties of interest have the same tax return as someone who did not do something built to taxable transactions." ❖

■ IRS VOWS NOT TO CHANGE TACTICS

IRS Loses 'Son of BOSS' Shelter Case on Multiple Arguments

The IRS has unexpectedly lost a "Son of BOSS" abusive tax shelter case just two months after an important win in another Son of BOSS case (*C.E. Sala*, DC-Colo., 2008-1 USTC ¶50,308, April 22, 2008). A federal district court found that the taxpayer-investor was entitled to the full amount of claimed losses—despite the IRS launch of a full salvo of previously successful arguments, including the sham transaction, step transaction and economic substance doctrines. The court also held that the anti-abuse trigger under Reg. §1.752-6 overstepped congressional authority. Nonetheless, IRS officials have indicated that they will not change their Son of BOSS strategy as a result of this one defeat.

Comment: "The government has established an impressive series of victories in tax shelter litigation," Charles Rettig, of Hochman, Salkin, Rettig, Toscher & Perez, P.C., Beverly Hills, Calif., told CCH. "However, *Sala* and *Klamath*, 2007-1 USTC ¶50,223 (another Son of BOSS case) demonstrate that the government must carefully

DISTRESSED ASSET TRANSACTIONS NOW COORDINATED ISSUE

The IRS will now treat transactions attempting to use trusts to shift built-in loss assets from a tax-indifferent party to a taxpayer who has not incurred an economic loss as a coordinated issue within the meaning of Section 4.51.2.5 of the Internal Revenue Manual (IRM). The IRS declared these distressed asset trust transactions as listed transactions for purposes of Reg. §1.6011-4(b)(2) and Code Sections 6111 and 6112 earlier this year in Notice 2008-34.

If IRS examination personnel now come across the transaction, they are required to notify an "issue champion" within the agency and obtain the champion's permission regarding examination techniques and any offering to resolve the issue outside of full taxpayer concession. Section 4.51.2.5 of the IRM also requires the IRS Small Business/Self-Employed Division and IRS Chief Counsel to meet subsequent to this publication and discuss the need for future IRS guidance on this issue, such as a Chief Counsel Notice, audit/handbook guide or revenue ruling.

analyze each transaction and must not rush to litigation on any particular transaction." Rettig added that the taxpayer in this case "did his research before investing and was found to be a credible witness, his tax and investment advisors were well-prepared and he was extremely well-represented at trial."

Transaction

The version of the alleged Son of BOSS abusive tax shelter that triggered the immediate litigation involved a foreign currency options investment transaction—a strategy, called the "Deerhurst investment plan." The taxpayer, who found himself with \$60 million in stock option income, bought into this Son of BOSS transaction to generate offsetting losses.

Court's analysis

The court found that the taxpayer's transaction was not a sham, but rather, was entered into for profit and as part of a long-term investment. As a result, first-year losses should not be analyzed separate from the ongoing, multi-year investment.

CCH Comment: In effect, the court found that the IRS chose the wrong case (that is, the wrong set of facts) to litigate this time, as opposed to prior successes based on more clearly abusive fact patterns. For example, this case was

“unlike the phony seven-year plan in *Klamath*” and “unlike *Associated Wholesale Grocers*, 91-1 USTC ¶150,389, any one step did not warrant application of the step transaction doctrine.”

Comment: “The sky is not falling on government efforts to curb aggressive tax planning,” Rettig observed. “However, the government must acknowledge that application of the profit motive and business purpose doctrines to a particular set of facts can lead to uncertain litigation results.”

Reg overruled

The court also found that Treasury exceeded its authority in creating Reg. §1.752-6. It acknowledged that Treasury was given authority under Section 309(c) of the Consolidated Appropriations Act of 2001 (CAA) (P.L. 106-170) to make rules preventing the “duplication of loss” through assignment of liabilities to a partnership. However, the court focused on the fact that the heading of Section 309(c) is labeled, “Application of Comparable Rules to Partnerships and S Corporations” (emphasis added by the court).

The court found that treatment of corporate liabilities under Code Sec. 385(h)(2)(B) versus treatment of liabilities assigned to partnerships under Reg. §1.752-6 were not “comparable” because they produced different outcomes in this situation. Reg. §1.752-6 provides what the court referred to as an “exception to an exception.” It requires partners in Son of BOSS transactions, as listed in Notice 2000-44, to reduce the amount of their partnership interest basis by the liability of the short position option. This differs from the exception provided to corporations in Code Sec. 385(h)(2)(B), allowing corporate shareholders to maintain a basis in their equity interest as long as “substantially all of the assets with which the liability is associated are transferred...as part of the exchange.”

The court also held that Reg. §1.752-6 was overly broad. Because Section 309(a) of the CAA created Code Sec. 358(h)(3) to regulate transactions between corporations and their shareholders, the court reasoned that the statute’s authorization of Treasury to create rules regarding “assumption of...liabilities described in section 358(h)(3)...in transactions involving partnerships” only applied to transactions between corporations and partnerships. Appli-

cation of the rule to partner-partnership transactions, according to the Court, was therefore outside Treasury’s authority.

No retroactivity

Finally, the court found that Reg. §1.752-6 could not be applied retroactively even if it was valid. The reg was Treasury’s attempt to “legislate an exception to the statutory exception to be applied only in Notice 2000-44 transactions,” the court concluded.

Comment: “A government appeal seems likely, and the government is not likely to decide to close up shop and go out of business based on *Sala*,” Rettig predicted. “It is difficult to determine what an appeals court may determine,” Rettig observed. “However, assuming an appeal, if the appeals court does not attempt to disturb the factual determinations, it could be difficult to overturn this decision.” ❖

Bond Short Sale Obligation Required to Reduce Partnership Basis

Following other decisions, the U.S. Court of Appeals for the Fifth Circuit recently denied a taxpayer’s claimed capital losses related to a variant on the “Son of BOSS” alleged abusive tax shelter (*Kornman & Associates Inc.*, CA-5, May 12, 2008). The court determined that the taxpayer’s actions through a family trust and several limited partnerships were a series of contrived steps to generate artificial tax losses designed to offset income. The entity, selling a limited partnership interest at the heart of the transaction, was required to include in its amount realized relief from liability related to a short sale of Treasury bonds. This ultimately reversed the taxpayer’s reported losses.

‘Son of BOSS’ variant

An individual taxpayer, acting through its trust, acquired bonds through a short sale and contributed the sales proceeds, plus the accompanying obligation to repay the bonds, to a limited partnership. The trust attempted to mask the exchange through a series of superfluous transactions. As a result, the trust owned a par-

ent limited partnership, which, in turn, owned a subsidiary limited partnership that assumed the short-sale obligation and retained its proceeds. Subsequently, the parent limited partnership transferred its interest in the subsidiary to a third party. Because neither the trust nor the parent limited partnership included the short-sale obligation in their outside partnership basis, the parent limited partnership eventually reported over \$100 million in short-term capital loss as a result of the sale of the subsidiary limited partnership. The trust used this tax loss to shelter its income over the course of three tax years.

Contingent liability

The taxpayer trust and parent limited partnership asserted in summary judgment and on appeal that the short-sale obligation was a contingent liability that did not reduce the basis of their outside partnership interest under Code Sec. 752. The government argued that the short-sale obligation fell within the plain meaning of Code Sec. 752, requiring both the trust and parent limited partnership to reduce their partnership interests.

CCH Comment: Unlike the taxpayer success in *C.E. Sala*, (DC-Colo., 2008-1 USTC ¶50,308, April 22, 2008), this case involved Treasury bonds, not options to acquire stock. Thus, while the *Sala* court relied upon *G. Helmer*, 34 TCM 727, Dec. 33,225(M), T.C. Memo 1975-160, to show liabilities created by short options were too contingent to be added to the outside basis in a partnership interest, this court found *Helmer* inapplicable.

Liability must be recognized

Using IRS revenue rulings as support, the court agreed with the government. Under Rev. Rul. 88-77, the court ruled that the short-sale obligation was a liability under Code Sec. 752. Under Rev. Rul. 95-26, the parent limited partnership was required to reduce the basis of its subsidiary limited partnership interest by its share of the short-sale obligation. According to Rev. Rul. 95-45, the amount of the short-sale liability was equal to its proceeds. As a result, the parent limited partnership's sale of the subsidiary had to realize both the compensation received and the relief from liability of the short-sale obligation. The total loss allowed was only around \$200,000. Further, the court denied the taxpayer's argument that the short sale was a "open transaction" for which no gain or

loss could be determined until the replacement bonds were purchased. It found no connection between calculation of gain or loss on short sales under Code Sec. 1223 and the effects on a partner's outside basis under Code Sec. 752. ♦

■ LMSB DIVISION COUNSEL COMMENTS ON LOSS

IRS Not Deterred by 'Bump in the Road' for Son of BOSS Litigation

A taxpayer's recent win in *C.E. Sala*, (DC-Colo., 2008-1 USTC ¶50,308, April 22, 2008) was "one pothole in the road as we move along to wrap up the Son of BOSS cases," according to Division Counsel of the IRS Large and Mid-Size Business Division (LMSB) Christopher Sterner. Sterner spoke to CCH on April 24 about the agency's defeat in *Sala*, declaring that its outcome was only a temporary setback. He promised continued Son of BOSS litigation in the future, pointing out the agency's admirable track record in prosecuting these issues.

Departure from precedent

Contrary to a recent string of IRS victories against alleged Son of BOSS abusive tax shelters, including such cases as *Jade Trading, LLC*, FedCl, 2008-1 USTC ¶50,112, and *Cemco Investors, LLC*, CA-7, 2008-1 USTC ¶50,178, the District Court of Colorado recently handed down a pro-taxpayer opinion allowing deductions that nullified a taxpayer's liability on more than \$60 million of income.

CCH Comment: This court previously ruled that the same taxpayer was entitled to a refund of interest on his alleged liability under Code Sec. 6404(g), finding that IRS had failed to show lack of credibility or mischaracterization of his transactions sufficient to prove fraud.

"From our perspective, we view this as a bump in the road with respect to the Son of BOSS litigation," Sterner stated, echoing IRS Chief Counsel Donald Korb's previous pronouncements on the agency's loss. "Donald Korb has said in the past that we have an awful lot of these cases and we anticipate that we might lose one or two along the way. But, clearly, the trend we have right now is successful for us. We

don't intend to change our approach to the Son of BOSS litigation at all as a result of the *Sala* opinion," he continued.

Reg. §1.752-6 Questioned

The court questioned the legality of Reg. §1.752-6, a weapon that has provided consistent successes for the IRS in previous Son of BOSS cases. Sterner explained that "in *Sala*, one of the things that we're concerned about is the judge finding that Reg. §1.752-6 is invalid. We view that as significant."

However, Sterner again emphasized that this ruling was an anomaly among other Son of BOSS cases. Court criticism of this regulation is rare. He declared, "we have the *Cemco* case, where the Seventh Circuit considered the same reg and found that it was valid. We certainly believe that the *Cemco* court had it correct. In addition to that [the court in] *Jade Trading* dealt with a similar situation, did a thorough analysis, and came to an opposite conclusion with respect to economic substance, as did the court in *Klamath*, (DC-Tex., 2007-1 USTC ¶50,223) with respect to the economic substance of the transaction."

Long and short options separated

Unlike many past cases, the *Sala* court even allowed the taxpayer separate treatment between the long- and short-position options he contributed to the partnership. This issue has ensnared many investors who attempt to artificially inflate their partnership basis by contributing the long options to the partnership, while avoiding accounting for the liability of the short position option. "We look at the facts differently than the judge in *Sala* did," Sterner stated, "In other cases, it's been found that you really can't separate the two. Obviously, Judge Babcock came to a different conclusion." ❖

'Son of BOSS' Investors Split Summary Judgment Holdings with IRS

The IRS has been slowed by another speed bump in its recent drive toward clearing Son of BOSS litigation off its calendar, using summary judgment whenever possible (7050, LTD, 95 TCM 1413, Dec. 57,417(M), T.C. Memo. 2008-112). In

addition to being on the losing end of a strong factual case in *C.E. Sala*, (DC-Colo., 2008-1 USTC ¶50,308, April 22, 2008), it also could not close another Son of BOSS case completely on summary judgment because, once again, its arguments were not persuasive enough for the court. Nor could it win summary judgment on a penalty issue that involved an issue already being litigated in two other courts.

Botched transaction

In this alleged Son of BOSS abusive tax shelter scheme, the IRS argued that the tax matters partner made several errors that almost crippled the transaction before the court could even consider its economic substance. The tax matters partner used a limited liability company to acquire a long-position foreign-currency option from a bank and concurrently sold an offsetting short-position option to the bank. The LLC also purchased Canadian currency. These assets were later contributed to the taxpayer partnership, the intended vehicle for the Son of BOSS transaction.

However, before the options were actually contributed to the partnership, IRS alleged that both had expired "out-of-the-money." This made them worthless when contributed and gave the LLC a zero tax basis. As a result, the partnership also had a zero basis in the assets under Code Sec. 723. Additionally, when the assets of the partnership were later distributed to the partners in liquidation, the distribution did not include the partnership's currently held Canadian currency. Retention of this currency, IRS argued, prevented the distribution from treatment as one made in liquidation as defined in Code Sec. 761(d). Because the distribution was not considered a distribution in liquidation, IRS continued, Code Sec. 732(a) required the partners to take a zero basis in the options they received from the partnership, rather than the inflated basis of their partnership interests that the investors desired.

Bonds not worthless

The court was lenient on the taxpayer investors in not treating the options that the tax matters partner contributed to the partnership as worthless ("out-of-the-money") at the time of their contribution. The court stated, "on a summary judgment motion, we have to draw inferences

in favor of the non-moving party." The court inferred from an affidavit presented by the partnership's attorney that the partnership and the bank orally agreed to transfer the options before the actual transfer and before they had expired.

Comment: Christopher Sterner, Division Counsel of the IRS Large and Mid-Size Business Division, told CCH, "The judge is required to look at all the facts in a way that's most favorable to the person against whom the motion is brought, which in this case is the taxpayer. I think the judge made it clear that he wasn't deciding the issue in any way. He was just saying that the fact that they had an affidavit saying there was a different understanding required that there had to be a trial on that issue."

No liquidation of interest

The IRS did win summary judgment on the liquidation-of-interest issue. The court ruled that distribution of the options to the partner was not in complete liquidation of the taxpayer's interest as required by Code Sec. 732(b) because the partnership still existed. No genuine issue of fact existed concerning the partnership's retention of Canadian currency in a bank account. The court found that this simple retention of currency was similar to the other kinds of partnership activity that it previously found in other cases to qualify as a partnership's continuation of business.

Comment: Sterner explained that it was the finding of the partnership's continued existence that ultimately reversed the court's previous leniency towards the taxpayer's position, stating "there was no loss in the [tax] year before the court because there was no termination." ❖

IRS Pursuing Tax Shelter Hold-Outs, Commissioner Warns

The government's campaign against abusive tax shelters has entered a new phase, IRS Commissioner Douglas H. Shulman told practitioners on May 9. "In this new phase, we are pursuing those hold-outs who chose not to settle [with the IRS]," Shulman said at the American Bar Association Section of Taxation 2008 May Meeting in Washington, D.C. Shulman also indicated his

COURT UPHOLDS GOVERNMENT'S DELIBERATIVE PROCESS AND ATTORNEY-CLIENT PRIVILEGES CLAIMS

A recently released federal court opinion grants protection to the government against disclosure of the majority of documents requested by several taxpayers involved in an alleged abusive tax shelter (*Nevada Partners Fund LLC*, DC-Miss., May 12, 2008). The taxpayers were accused of participating in family office customized partnerships (FOCUS) transaction aimed at artificially generating over \$18 million in capital losses in order to offset over \$18 million in capital gain. As part of the discovery process, they submitted several unanswered requests for documents to the government. They subsequently filed a motion to compel their disclosure.

All documents. The court held that the taxpayer's request for all documents reviewed, prepared or relied upon by the government in preparing any relevant notice of final partnership administrative adjustment (FPAA) was unreasonably broad. Additionally, these documents were protected by both the deliberative process and attorney-client privileges.

Notice 2002-50. The court also denied the taxpayer's motion to compel the government to produce documents relied upon in preparation of Notice 2002-50. Due to its *de novo* review, the court found that it does not look past the FPAA itself to determine the validity of the government's adjustments to the taxpayer's tax position. Therefore, it found that these documents were not "reasonably calculated to lead to the discovery of admissible evidence."

Documents received. The taxpayer was successful however in obtaining several documents discussing its ability to generate a pre-tax profit from their investments and redacted records and reports of government employees created during the taxpayer's examination.

support for enhanced information reporting to increase compliance.

CCH Comment: Shulman did not address the one topic on the mind of many practitioners, the imminent release of proposed Code Sec. 6694 regulations. CCH has learned from sources that the Service expects to release the proposed regulations on May 12 or 13.

Tax shelters

Shulman divided the IRS's anti-tax shelter activity into three phases. "In the first phase, the IRS aggressively rooted out abusive tax shelters and brought some significant cases. In the next phase, a number of taxpayers acknowledged that participating in these shelters was a mistake and settled."

PARTNERS ENTITLED TO REFUND OF ENHANCED INTEREST PAID AT TAX-MOTIVATED TRANSACTION RATE

The U.S. Tax Court recently found that individual partners were entitled to a refund of enhanced interest imposed by the IRS at the tax-motivated transaction rate under former Code Sec. 6621(c) (*T.H. McGann*, FedCl, 2008-1 USTC ¶50,321). The partners were not liable for the additional interest because their underpayment of taxes was not attributable to a tax-motivated transaction.

The IRS applied the enhanced interest rate following the Tax Court's dismissal of the partnership's petition to review the Final Partnership Administrative Adjustment issued to it. However, in its dismissal order, the Tax Court ordered adjustments to the partnership's return disallowing certain deductions, but it allowed other deductions that the partnership had originally claimed; it did not determine that the partnership's transactions were a sham or tax-motivated. In the absence of such an explicit finding by the Tax Court, the IRS's assessment of tax-motivated interest under was improper.

Now, the IRS is in the third phase of its anti-shelter campaign: bringing to trial taxpayers who refused to settle. "The government has won the overwhelming number of these cases," Shulman said.

Shulman's promise of victory comes shortly after the government suffered a setback in its tax shelter litigation by recently losing a Son of BOSS transaction case (*C.E. Sala*, DC-Colo.,

FORM AVAILABLE TO MATERIAL ADVISORS FOR MAINTAINING ITEMIZED STATEMENT COMPONENT OF REPORTABLE TRANSACTION LIST

As of May 1, 2008, material advisors required to maintain lists under Code Sec. 6112 may use Form 13976, *Itemized Statement Component of Advisee List*, for the purpose of preparing and maintaining the itemized statement component of the list with respect to a reportable transaction (Rev. Proc. 2008-20, 2008FED ¶46,422). The IRS has determined that the use of Form 13976 should simplify the method of list maintenance with respect to the itemized statement and reduce the burden on material advisors trying to comply with the regulations under Code Sec. 6112.

A material advisor may use the form as a template for creating a similar form, including a spreadsheet, on a software program used by the material advisor. Use of the new form is optional; material advisors are not required to use the form in order to comply with the law. The form and instructions for its use are available on the IRS Web site.

2008-1 USTC ¶50,308). However, the Court of Appeals for the Fourth Circuit handed the IRS a victory in a lease-in, lease-out (LILO) transaction case (*BB&T Corp.*, CA-4, 2008-1 USTC ¶50,306) less than a week later.

Information reporting

"I am inclined to support information reporting regimes that allow taxpayers and tax administrators to start the process with transparent and consistent information," Shulman said. The Bush administration has proposed enhanced information-reporting requirements for stock basis reporting and merchant credit card payments. "I would welcome the day that a taxpayer needing to report capital gains would get that information on a year-end form in a consistent format, rather than doing it himself and worrying that the data is correct."

"I see correct information about 40 percent of the time from brokers," **Claudia Hill**, EA, Cupertino, Calif., told CCH after Shulman's remarks. Hill, who is Editor-in-Chief of CCH's *JOURNAL OF TAX PRACTICE & PROCEDURE*, questioned if the IRS will have a "fail safe" when information is incorrect. "The IRS assumes information on a Form 1099 is always correct."

Globalization

Tax administration is global today, Shulman said. "Businesses are no longer defined by national borders. The cross border migration of capital and people has made this a more integrated world."

Shulman, who has an extensive background in international business after serving as vice chair of the Financial Industry Regulatory Authority (FINRA) before being appointed IRS Commissioner earlier this year, indicated that the IRS will be adapting to the globalization of tax administration. "The IRS needs to ensure it has the tax administration capabilities to deal with the fast pace of change."

Transparency

Shulman reiterated the Service's emphasis on transparency, but appeared to indicate that transparency is a two-way street. "IRS personnel must not confuse greater transparency with greater authority over taxpayers," he said. He

briefly highlighted some of the Service's recent projects that are intended to enhance transparency, such as the new Form 990, *Return of Organization Exempt from Income Tax*.

Guidance

Finally, Shulman pledged that the Service will issue "clear" guidance, but acknowledged that achieving a high degree of clarity is "difficult." When guidance is unclear and is subject to multiple interpretations, the Service is contributing to noncompliance, he said. ♦

LMSB Trains Examiners on Application of Code Sec. 6694 Penalties

The IRS Large and Mid-Size Business Division (LMSB) recently released an industry directive memorandum on the procedures for examiners to follow in applying the controversial return preparer penalties under Code Sec. 6694 (LMSB-04-0308-009). They indicate the need for restraint and review, but also encourage examiners to look for instances in which the new preparer penalty standard might be applied.

The procedures instruct examiners on how to look for situations involving the penalty, as well as how to conduct the return preparer penalty examination itself. Examiners are also warned about applicable statutes of limitations, in addition to the required referral to the IRS Office of Professional Responsibility (OPR) for these cases.

CCH Comment: Similar training materials have not yet been made public for taxpayers within other divisional IRS jurisdictions, such as Small Business/Self-Employed (SB/SE).

Looking for evidence

Under the procedures, LMSB examiners are encouraged to look for signs of applicability of the return preparer penalty during every field examination they perform regarding a taxpayer's tax liability. Once a possible penalty situation is identified, the examiners must obtain their team manager's approval and contact the LMSB return preparer coordinator before beginning an actual examination of the income tax return preparer. The result of this higher-level review, the training materials advise, can

IRS MUST SHARE LENIENT 'TEST CASE' SETTLEMENT TERMS WITH ENTIRE CLASS

An IRS attorney, in 1985, convinced a Tax Court judge to have several "test cases" regarding the liability for thousands of participants in the so-called Kersting tax shelters (*L.L. Hartman*, CCH Dec. 57,431(M), TC Memo. 2008-124). Liability for the majority of investors in so-called Kersting tax shelters hinged upon the results of these several cases. However, the attorney secretly agreed to a settlement with several of the taxpayers in the test cases before trial and reimbursement of their attorney's fees, in exchange for remaining in the test case. While the Tax Court imposed sanctions against the IRS attorneys involved upon revelation of these secret settlements, it did not overturn their settled liabilities, which were negligible in comparison to those imposed upon other participants.

After several rulings from the Court of Appeals for the Ninth Circuit, the Tax Court had a change of heart and agreed to vacate the closed judgments of the other tax shelter participants, as well as instill further sanctions against the IRS. The court found that, rather than a mere error, the IRS attorneys' failure to disclose the settlements was a fraud upon the court that could not be purged by simple disclosure.

range from taking no action to labeling the case as involving "pervasive and widespread" abuse, which may cause the manager and return preparer coordinator to open a "Program Action Case" against the preparer. Under this latter regime, the IRS investigates all of the preparer's clients to determine whether penalties or injunctive actions against the preparer need to be undertaken.

LMSB prohibits IRS examiners from proposing or discussing the penalties in the presence of a preparer's taxpayer-clients. Instead, LMSB directs them to interview the taxpayer as part of the taxpayer's examination, while seeking documentation that may confirm suspicions about the preparer. Among other questions, the division suggests asking the taxpayer:

- Did you receive a copy of the return or claim?
- Are you aware of any errors, omissions or mistakes on the return under examination?
- Did you disclose this transaction on your tax return? Why? Why not?
- Was there any discussion regarding whether the transaction is subject to disclosure under Rev. Proc. 94-69?

OPR referral

Whether the preparer agrees or disagrees with assessment of the return preparer penalty, LMSB instructs its examiners that the assessment is required to be reported to the OPR. This applies to penalties under Code Sections 6694(a), 6694(b), 6695(f) and 6701. ❖

IRS Continues Winning Streak with Sale-In, Lease-Out Transaction Decision

The IRS continues to stack-up tax shelter wins in court, including a recent sale-in, lease-out (SILO) transaction (*AWG Leasing Trust*, DC-Ohio, May 28, 2008). In this case, a federal district court found that, while the transaction had some economic substance apart from the tax benefits, the taxpayer's claim that it was a "sale" was not consistent with economic reality. The taxpayers never had an ownership interest sufficient to obtain a depreciable interest in the property.

CCH Comment: The SILO property in this case was in Germany, a popular location for these transactions. German subways, sewer systems, wireless networks and other pieces of infrastructure have been involved in SILO transactions.

Background

Acting through a business trust, the taxpayers entered into a leveraged leasing transaction for the sale and lease back of a waste-to-energy facility located in Germany, owned and operated by a group of German municipalities. The taxpayers paid more than \$400 million in a purported purchase of the facility, and then called for the municipalities to lease it back.

The taxpayers each owned a 50-percent interest in the trust, which was treated as a partnership for federal income tax purposes. The trust chose to have the tax treatment of all partnership items determined at the partnership level. As a result, the taxpayers each reported income in the form of accrued rent payments under the leaseback agreement and deductions for depreciation and amortization. The IRS determined that the taxpayers did not become the

owners of the facility for purposes of U.S. tax laws and could not claim tax benefits associated with ownership.

Court's analysis

The court first noted that it should respect the transaction if it accurately reflected the underlying rights and responsibilities held and allocated between the parties. If the substance and form did not comport, the court found, the substance of the transaction controlled for federal tax purposes.

CCH Comment: SILOs, the court observed, are modified versions of lease-in, lease-out (LILO) transactions. SILOs differ from LILOs by having a longer-term head lease that purports to qualify as a sale for tax purposes. The Sixth Circuit, to where an appeal would lie in this case, has not addressed SILOs, the court observed.

A SILO may have economic substance, the court noted, if the taxpayer has a reasonable possibility of generating a pre-tax profit. Here, the court found that the taxpayers could have reasonably expected to make a small pre-tax profit. Consequently, the transaction was not an economic sham.

However, the court found that taxpayers did not bear the burdens or enjoy the benefits of ownership. Under the terms of the transaction, the German municipalities retained all important ownership interests. They operated, maintained and made improvements to the facility. They paid all taxes and costs on the facility. Indeed, they assured German authorities that possession of the facility would not transfer to the taxpayers. The taxpayers, on the other hand, never took legal title to the facility. The transaction was not even intended to be sale under German law. Furthermore, the court found that the transaction did not carry any credit risk for the taxpayers. The rent payments were guaranteed by German banks.

According to the court, the IRS also correctly disallowed the various depreciation and amortization deductions. The taxpayers, through the leasing trust, were never owners of the facility for federal tax purposes, the court concluded. The court also denied deductions for interest paid on the underlying transaction loans because there was no genuine indebtedness. ❖