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All Industries
"Notice 2003-81" Tax Shelter
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INTRODUCTION

On December 4, 2003, the Service issued Notice 2003-81, 2003-2 C.B. 1223, announcing that it will challenge transactions involving the assignment of offsetting foreign currency options to a charity in order to claim substantial artificial net losses and identifying these transactions as listed transactions for purposes of I.R.C. §§ 6011, 6111, and 6112. The transaction is designed to create an overall net loss (either ordinary or capital) when a taxpayer transfers two foreign currency contracts to a charity where only one such contract is subject to the mark-to-market rules contained in I.R.C. § 1256.

ISSUES

1. Whether the tax law permits premium income received on a taxpayer's written "minor" foreign currency option contracts to go untaxed where the taxpayer retains the premium but transfers the obligation associated with the written option to a charity.

2. Whether a taxpayer participating in this shelter strategy obtained a timing benefit by being able to recognize a loss on a purchased foreign currency option in advance of gain recognition on the premium received for writing a foreign currency option.

3. Whether a taxpayer's purported loss is a bona fide loss allowable under I.R.C. § 165.

4. Whether the at-risk provisions of I.R.C. § 465 limit the taxpayer's claimed loss.

5. Whether the transaction as a whole lacks economic substance and business purpose apart from tax savings.

6. Whether the provisions of I.R.C. § 988 limit a taxpayer's claimed foreign currency losses.

7. Whether the Service should assert the appropriate I.R.C. § 6662 accuracy-related penalty against a taxpayer who entered into the transaction.

8. Whether the Service should examine the role of the charity in this transaction.

SUMMARY OF CONCLUSIONS

1. A taxpayer remains obligated to take into income the premium received for writing a "minor" foreign currency option contract even if it transfers the obligation associated with that written option to a charity.

2. A taxpayer did not obtain a timing benefit because I.R.C. § 1092 does not permit a taxpayer to recognize loss in advance of gain on offsetting foreign currency contracts.

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

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

5. The taxpayer's loss is disallowed because the transaction as a whole lacks economic substance and business purpose apart from tax savings.

6. The taxpayer is not entitled to an ordinary loss under I.R.C. § 988.

7. The 20-percent accuracy-related penalty under I.R.C. § 6662 should be asserted against a taxpayer entering into this transaction unless the taxpayer is able to establish reasonable cause and good faith under I.R.C. § 6664(c)(1) and the applicable regulations.

8. The agent examining the taxable entity should forward all information gathered about the involvement of the charity to the Exempt Organizations Division of TEGE through the process established by the Notice 2003-81 Issue Management Team.

FACTS

A. Background

Taxpayers deployed Notice 2003-81 transactions in order to offset substantial taxable income (either capital or ordinary). Taxpayers initiated the transactions by entering into an investment management agreement and opening a trading account managed by the promoter, who is also a registered investment advisor. Generally, the initial capital investment is determined by the anticipated loss needed. The required investment amount is equal to either (1) 15% of the desired ordinary loss or (2) 10% of the desired capital loss. The taxpayer agrees to leave the funds in the account for a five-year period, although funds can be withdrawn at any time subject to significant monetary penalties. A small portion, approximately 1.75%, of the initial capital investment is used to establish a foreign currency trading account that is used to purchase foreign currency option contracts. The remaining balance is invested in a hedge fund of funds that in turn invests in a variety of investment vehicles including other hedge funds, stock funds, commodity funds and currency funds.

B. <u>Foreign Currency "Investment" Strategy</u>

The foreign currency "investment" strategy involves the purchase and sale of a series of foreign currency option contracts denominated in both a foreign currency in which positions are traded through regulated futures contracts and a foreign currency that is not traded through regulated futures contracts. The values of the two currencies underlying the options (i) historically have demonstrated a very high positive correlation with one another, or (ii) officially have been linked to one another, such as through the European Exchange Rate Mechanism ("ERM II").[1] In one version, the taxpayer buys two 180-day European-style digital currency options, pegged to fluctuations in the exchange rate between the U.S. dollar and the euro. These positions are in a foreign currency traded through regulated futures contracts, and thus the taxpayer takes the position that such positions are I.R.C. § 1256(g)(2)(A) foreign currency contracts. In the promotional materials, these contracts are referred to as the "major options." At the same time, the taxpayer sells two 180-day European-style digital currency options, pegged to fluctuations in the exchange rate between the U.S. dollar and a stated European currency. The European currency is one in which positions are not traded on a qualified board or exchange and are not I.R.C. § 1256(g)(2)(A) foreign currency contracts. In the promotional materials, these contracts are referred to as the "minor options." The counterparty is the same for all four currency contracts. Therefore, the initial cash outlay to enter into the foreign currency positions is limited to the net premium among the offsetting contracts.

In a more complex variation of the transaction, the taxpayer enters into a series of 180-day European-style digital options on the same day. Usually, the taxpayer buys two put options and sells two call options pegged to fluctuations in the exchange rate between the U.S. dollar and the euro. This group of options comprises the "major options." The taxpayer also buys two call options and sells two put options, pegged to fluctuations in the exchange rate between the U.S. dollar and a stated European currency. This group of options comprises the "minor options." Again, the counterparty is the same for all eight currency contracts and the initial cash outlay is relatively small in reference to the stated notional amounts of the contracts. In some deals, the taxpayer will enter into a second series of 180-day European-style options on the following day.

The values of the respective currencies underlying the foreign currency transactions historically have demonstrated a very high positive correlation with one another. Therefore, the major options will move inversely to the minor options such that any gain in a major foreign currency position will be largely offset by a corresponding, though not always identical, loss in a minor foreign currency position. The bank, which serves as counterparty for these deals, generally makes representations to the taxpayer and

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[1] In the transactions examined thus far, the strategy consists of the purchase and sale of a series of foreign currency option contracts denominated in both the euro and a currency of a European country (usually the Danish krone) that participates in the ERM II for fixing the participating currency exchange rate against the euro within a narrow fluctuation band.

trader concerning the statistical probabilities of the potential rate of return from the option positions indicating a profit is possible but unlikely. In fact, according to the analysis provided by the bank, there is usually a better than 50% chance that the taxpayer will lose its entire investment.

C. Assignment of Major and Minor Contract to Charity

Prior to the exercise date, that taxpayer assigns two of its open foreign currency contracts to a charity. The first contract is a major currency option contract that is in a loss position at the time of assignment. The taxpayer also assigns the obligation that is associated with a minor currency option contract that is in a gain position at the time of assignment of the obligation. The taxpayer takes the position that (1) the assignment of the major contract (i.e., I.R.C. § 1256 contract) is treated as a termination of the contract requiring recognition of the inherent gain or loss in such contract; and (2) the assignment of the minor contract obligation does not trigger the recognition of income because that contract is not covered by the mark-to-market provisions contained in I.R.C. § 1256.

D. Reporting of Transaction for Federal Income Tax Purposes

In some cases, the taxpayer will report the listed transaction on Form 4797, Part II, Ordinary Gains and Losses as an I.R.C § 988 foreign currency transaction. The loss claimed is a direct result from the disparate reporting of the donated major and minor contracts. The major contract in a loss position and the remaining option contracts that are not assigned to the charity are accounted for on Form 4797. The remaining option contract positions when closed effectively offset one another. The reporting exclusion of the gain from the donated minor contract, which closely mirrors the loss reported from the donated major contract, creates the artificial loss claimed by the taxpayer. In other cases, the taxpayer will report the listed transaction on Schedule D, Capital Gains & Losses. In these instances, the taxpayer makes an election pursuant to I.R.C. § 988(a)(1)(B) and Treas. Reg. § 1.988-3(b)(4) to treat its foreign currency contracts as capital assets in order to claim a capital loss. The taxpayer is required to attach a verification statement to its filed return for a valid capital treatment election.

DISCUSSION

1. A taxpayer remains obligated to take into income the premium that it received when it writes a "minor" foreign currency option contract and later transfers the obligation associated with that written option to a charity.

Gain and loss on options is accounted for on an open transaction basis. As explained in Notice 2003-81, the justification for open transaction treatment is that the gain or loss on an option cannot be finally accounted for until such time as the option is terminated. Thus, premium income is not recognized until an option is sold or terminated. Rev. Rul. 58-234, 1958-1 C.B. 279, Accord Rev. Rul. 78-182, 1978-1 C.B. 265; Koch v.Commissioner, 67 T.C. 71 (1976), acq. 1980-2 C.B. 1. Rev. Rul. 58-234 explains that

this is the treatment for the option writer because the option writer assumes a burdensome and continuing obligation, and the transaction therefore stays open without any ascertainable income or gain until the writer's obligation is finally terminated. When the option writer's obligation terminates, the transaction closes, and the option writer must recognize any income or gain attributable to the prior receipt of the option premium.

Though each taxpayer's transaction should be evaluated independently, the assignment documents reviewed to date have been three-party arrangements (involving the option writer, holder and charity) that seem to give rise to a novation of the option contracts. Where there is a novation, the option writer's obligation under the minor option contract terminates on the charity's assumption of the written option obligation. However, in other cases where a novation does not occur, the writer of the minor foreign currency option writer may well have a continuing obligation because the writer may be called upon to perform if the charity fails to perform or to reimburse the charity for any losses or expenses it may incur if called upon to perform.

If an assumption of the liability by the charity causes the option writer's obligation under the option contract to terminate, then the option writer must recognize gain upon assignment, when the option obligation is assumed. Notice 2003-81. If the assumption does not terminate the option writer's obligation under the option contract, the option writer must recognize the premium when the option writer's obligation under the option contract terminates (other than through an exercise of the option against, and performance by, the option writer). Notice 2003-81. It is generally understood that charities that received these options may have terminated them either contemporaneous with or shortly after the assignments.

Even if a novation did not occur to cause premium income to be recognized, there is still no support for the apparent contention that responsibility for recognizing premium income shifts to the charity as a result of the assignment of the obligation on the written option. At least some of the tax promotional materials associated with this shelter transaction suggest that the gain or premium income received by the taxpayer on the written option must be recognized by the charity (but goes untaxed because of its tax-exempt status). However, there is no support for this "too good to be true" result. Rather, the taxpayers and their advisors seem to simply assume that a taxpayer can receive premium income, pass off the obligation associated with having received that premium and not be taxed on the premium. No discussion was found in the materials, including an undated draft shelter memorandum ("Shelter Memorandum"), that explains why the premium received by the taxpayer is not a taxable accession to wealth of the taxpayer. Nor is there any explanation as to how a charity could be taxed on this premium that the charity does not receive.

There is some hint in the promotional materials that the promoters may have been seeking to pass off the transfer of the obligation on the written minor option as a "donation." Generally, taxpayers do not recognize gain upon transfer of appreciated property to a qualified charity. See Rev. Rul. 55-138, 1955-1 C.B. 223, modified on

other grounds by Rev. Rul. 68-69, 1968-1 C.B. 80. In these challenged transactions, however, property rights were not transferred – only the obligation associated with the out-of-the money (losing) purchased option was transferred. The assumption of an obligation is not a donation of property to which I.R.C. § 170 applies. Rather it is a disposition event governed by I.R.C. § 1001. Crane v. Commissioner, 331 U.S. 1 (1947). If the assumption of the obligation by the charity also involves the donation of associated property, I.R.C. § 1001(b) applies and the transaction is treated as a bargain sale.[2] Treas. Reg. § 1.1011-2(a)(3); Ebben v. Commissioner, 783 F.2d 906 (9th Cir. 1986). Thus, to the extent there was a transfer of property along with an associated obligation, the taxpayers were, in general, properly advised in this scheme that their charitable deduction for the donated purchased option rights would be reduced by the amount of liability relief provided by the charity that assumed the obligation on the written minor option.

In short, contrary to the advice apparently received by the taxpayers, there is no factual or legal basis for the contention that taxpayers in these shelters shifted the responsibility for recognizing the premium income or gain on the written minor option position to a charity. Rather, the taxpayers only transferred an obligation and must be taxed on the premium that they retain.[3]

2. A taxpayer did not obtain a timing benefit because section 1092 does not permit a taxpayer to recognize loss in advance of gain on the offsetting foreign currency contracts.

For several reasons, this foreign currency shelter transaction did not provide a timing benefit to participating taxpayers.

As explained in issue 1, the open transaction doctrine deferred a taxpayer's recognition of premium income only until it became possible to finally account for the option transaction. As also indicated, a taxpayer will be required to pick up premium income on the minor option at the same time as loss is allowed on the major option under I.R.C. § 1256(c) if there was a novation of the minor option. However, even if a novation did not occur, a taxpayer was still required to recognize income when that taxpayer's secondary obligation under the written minor option contract terminated. That may have occurred in the same tax year as the assignment because the options were short term and are understood to have been closed out by the charities either contemporaneous with or shortly after assignment.

[2] I.R.C. § 170(e) may also affect the amount of the donation.
[3] Because only an obligation is transferred, there is no need to consider whether the premium would be taxed to the taxpayer under the assignment of income doctrine. It stands to reason, however, that if the assignment of income doctrine applies to certain transfers of income rights to charities, it should have been more than obvious to the promoters of this shelter that transferring the obligation but not the premium to a charity would not cause the responsibility for paying tax on the premium to be shifted to the charity.

However, even if a charity kept open the written option obligation beyond the year of assignment, a taxpayer still would not have obtained an overall timing advantage. As indicated in Notice 2003-81, the purchased major foreign currency option and the written minor foreign currency option are substantially offsetting positions. Consequently, such positions were parts of a straddle subject to I.R.C. § 1092. Thus, under I.R.C. § 1092, any mark-to-market loss on the contributed major foreign currency option would have been appropriately deferred to the extent of the taxpayer's unrecognized gain on the written minor foreign currency option.

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

I.R.C. § 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Treas. Reg. § 1.165-1(b) provides that to be allowable as a deduction under I.R.C. § 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in I.R.C. § 165(h) and Treas. Reg. § 1.165-11 (relating to disaster losses), actually sustained during the taxable year. Under I.R.C. § 165(b), the amount of the loss from the sale or other disposition of property is the adjusted basis provided in I.R.C. § 1011. Treas. Reg. § 1.165-1(b) further states that only a bona fide loss is allowable and that substance and not mere form shall govern in determining a deductible loss. See also ACM Partnership v. Commissioner, 157 F.3d 231, 252 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999) ["Tax losses . . . which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations"]. Section 165(c) provides that, in the case of an individual, the deduction under § 165(a) is limited to losses incurred in a trade or business, losses incurred in a transaction entered into for profit, and certain casualty or theft losses.

In this case, the taxpayer has suffered no real economic loss because the acquisition and disposition of the offsetting option contracts constitute an economically inconsequential investment, with the taxpayer effectively in the same economic position as prior to the purported investment strategy less fees paid to the promoter. See ACM Partnership v. Commissioner, 157 F.3d at 251-252. Accordingly, the loss is not allowable under I.R.C. § 165.

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

The taxpayer's potential profit from this transaction, apart from tax savings, is statistically improbable. Moreover, any profit generated would likely be derived from the capital that was invested in the hedge fund of funds rather than the small amount of capital used to acquire the major and minor contracts. In fact, the tax materials distinguish the two investment components by opining that the "possible profits" from the tax-driven currency option trading and the "expected profits" from investing in the hedge funds create sufficient "economic substance". Therefore, it is unlikely that a taxpayer can demonstrate a reasonable expectation to earn more than minimal profit solely from the foreign currency investment strategy described above, apart from tax savings. See Knetsch v. United States, 348 F.2d 932, 938 (Ct. Cl. 1965) [The statutory definition of profit under I.R.C. § 165(c)(2) "cannot embrace profit seeking activity in which the only economic gain derived therefrom results from a tax reduction."]. Therefore, the loss is disallowed under I.R.C. § 165(c)(2).

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

I.R.C. § 465 generally limits deductions for losses in certain activities to the amount for which the taxpayer is at-risk. In the case of an individual taxpayer, I.R.C. § 465 limits the taxpayer's losses to the amount for which the taxpayer is at risk in the activity. I.R.C. § 465(a)(1). I.R.C. § 465 applies to all activities engaged in by the taxpayer in carrying on a trade or business or for the production of income. I.R.C. § 465(c)(3)(A). Under those sections, losses incurred in an activity engaged in by a taxpayer carrying on a trade or business or for the production of income is defined broadly to include "excess of the allowable deductions allocable to the activity over the income received or accrued by the taxpayer during the taxable year from the activity." Lansburgh v. Commissioner, 92 T.C. 448, 454-55 (1989). This interpretation is supported by the legislative history of I.R.C. § 465 that provides the at risk limitation applies to losses "regardless of the kind of deductible expenses which contributed to the loss." S. Rept. 94-938, at 48 (1976), 1976-3 C.B. (Vol.3) 86. In this case, I.R.C. § 465 applies to the loss stemming from taxpayer's purchase of the foreign currency option contracts.

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

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

The case law, however, is not in complete accord on this issue. In Emershaw v. Commissioner, 949 F.2d 841, 845 (6th Cir. 1991), the court adopted a worst-case scenario approach and determined that the issue of whether a taxpayer is “at risk" for purposes of I.R.C. § 465(b)(4) “must be resolved on the basis of who realistically will be the payor of last resort if the transaction goes sour and the secured property associated with the transaction is not adequate to pay off the debt.” quoting Levy v. Commissioner, 91 T.C. 838, 869 (1988). In contrast, the Second, Eighth, Ninth, and Eleventh Circuits look to the underlying economic substance of the arrangements under I.R.C. § 465(b)(4). Waters v. Commissioner, 978 F.2d 1310, 1316 (2d Cir. 1992) (citing American Principals Leasing Corp v. United States, 904 F.2d 477, 483 (9th Cir. 1990); Young v. Commissioner, 926 F.2d 1083, 1089 (11th Cir. 1991); Moser v. Commissioner, 914 F.2d at 1048-49. The view, as adopted by these circuits, is that, in determining who has the ultimate liability for an obligation, the economic substance and the commercial realities of the transaction control. See Waters v. Commissioner, 978 F.2d at 1316; Levien v. Commissioner, 103 T.C. 120; Thornock v. Commissioner, 94 T.C. 439, 448 (1990); Bussing v. Commissioner, 89 T.C. 1050, 1057 (1987). To determine whether a taxpayer is protected from ultimate liability, a transaction should be examined to see if it “is structured - by whatever method - to remove any realistic possibility that the taxpayer will suffer an economic loss if the transaction turns out to be unprofitable.” American Principals Leasing Corp. v. United States, 904 F.2d at 483; See Young v. Commissioner, 926 F.2d at 1088; Thornock v. Commissioner, 94 T.C. at 448-49; Owens v. United States, 818 F.Supp. 1089, 1097 (E.D. Tenn. 1993); Bussing v. Commissioner, 89 T.C. at 1057-58. “[A] binding contract is not necessary for [I.R.C. § 465(b)(4)] to apply.” American Principals Leasing Corp. v United States, 904 F.2d at 482-83. In addition, “the substance and commercial realities of the financing

arrangements presented . . . by each transaction" should be taken into account under I.R.C. § 465(b)(4). Thornock v. Commissioner, 94 T.C. at 449. To avoid the application of I.R.C. § 465(b)(4), there must be more than "a theoretical possibility that the taxpayer will suffer economic loss." American Principals Leasing Corp. v United States, 904 F.2d at 483.

In the typical "Notice 2003-81" deal, the counterparty to all the foreign currency contracts is the same. Due to the fact that the currency movements between the euro and European currency used in the minor contracts closely parallel each other, the taxpayer's cash investment is relatively small. The transaction is carefully structured so that any gain in one option position is largely offset by a loss in another contract. Therefore, the taxpayer's true at-risk amount equals the net out of pocket premium paid to acquire the aggregate offsetting foreign currency positions.

5. The taxpayer's loss is disallowed because the transaction as a whole lacks economic substance and business purpose apart from tax savings.

In addition to the statutory provisions discussed herein, the taxpayer's purported loss may be disallowed under the economic substance doctrine. This approach would deny the tax benefits arising because the transaction does not result in a meaningful change to the taxpayer's economic position other than the manufactured loss that results in the purported reduction in tax. See Knestch v. United States, 364 U.S. 361 (1960). The Tax Court has stated that tax law "requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction." ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part, 157 F.3d 231 (3rd Cir. 1998). Accordingly, this doctrine is applicable to the typical Notice 2003-81 transaction where the purported tax benefits are unintended by Congress and accomplished by a prearranged deal that serves no economic purpose apart from tax savings.

In determining whether a transaction is to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation are considered. ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3d Cir. 1998); Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990). Some courts apply a conjunctive analysis that requires a taxpayer to establish the presence of both economic substance (i.e., objective test) and business purpose (i.e., subjective test to determine whether the taxpayer intended the transaction to serve some useful non-tax purpose). See Pasternak v. Commissioner, 990 F.2d 893, 898 (6th Cir. 1993). Other courts apply a less stringent test that either a subjective business purpose or actual economic substance is sufficient. Rice's Toyota World v. Commissioner, 752 F.2d 89, 91-92 (4th Cir. 1985). An alternative analysis views economic substance and business purpose as "simply more precise factors to consider" in determining whether a transaction has any practical economic effects other than the tax benefits created. ACM Partnership v. Commissioner, 157 F.3d at 247. See also Casebeer v. Commissioner, 909 F.2d at 1363; Sacks v. Commissioner, 69 F.3d 982, 985 (9th Cir. 1995); James v.

Commissioner, 899 F.2d 905, 908 (10th Cir. 1995). In addition, several courts have applied the economic substance doctrine where a taxpayer was exposed to limited risk and the transaction had a theoretical potential for profit but the profit potential was nominal and insignificant when compared to the tax benefit derived. Gregory v. Helvering, 293 U.S. 465 (1935) [Transaction that is entered into for the primary purposes of creating a loss is subject to special scrutiny to determine whether such loss was bona fide]; Knetsch v. United States, 364 U.S. 361 (1960) [Leveraged acquisition of Treasury bills and accompanying prepaid interest deduction lacked economic substance]; Goldstein v. Commissioner, 364 F.2d 734 739-40 (2d Cir. 1966)[Deduction disallowed even though taxpayer has a possibility of small gain or loss from ownership of Treasury bills]; Sheldon v. Commissioner, 94 T.C. 738, 768 (1990)[Loss disallowed from prearranged substantially offsetting transaction where profit potential "infinitesimally nominal and vastly insignificant" in comparison to loss claimed]; Rice's Toyota World v. Commissioner, 752 F.2d at 94; [Economic substance inquiry requires an objective determination of whether reasonable possibility of profit existed apart from tax benefits]. See also Compaq Computer Corp v. Commissioner, 277 F.3d at 781; IES Industries v. United States, 253 F.3d at 354 [Applying same objective economic substance test discussed in Rice's Toyota World].

The doctrine of economic substance should be raised in cases where the facts show that the transaction at issue was primarily designed to generate the tax losses, with little if any possibility for profit, and that such was the expectation of all the parties to the transaction. The wide variety of facts required to support its application should be developed at examination. The administrative record should include documents obtained from the taxpayer, the promoter and other third parties; interviews with the same; and expert analysis of financial data and industry practices. Summonses should be promptly issued whenever necessary to obtain the requisite transactional documents.

In addition to evidence that shows a lack of pre-tax profit potential, facts should be developed demonstrating that the taxpayer and the promoter primarily planned the transaction for tax purposes. Such evidence should include the following: (1) documents or other evidence that the foreign currency option contracts were sold as tax shelters with limited consideration of the underlying economics of the transaction; and (2) evidence that a prudent investor would not have invested in the strategy but for the tax savings. A primary source of such evidence is correspondence between the promoter and the taxpayer, including, but not limited to, offering memos, letters identifying tax goals, e-mails and in-house communications at the offices of the promoter and any other third party involved in the strategy. Written correspondence is the best evidence, but evidence of oral communications regarding tax goals is also useful. Indirect sources of the same include correlations between tax losses generated and tax losses requested, and between the taxpayer's income and the tax losses generated, particularly if it can be shown that the income to be sheltered was attributable to an unusual windfall, like the liquidation of stock options, or sale of a business. Demonstrations of similarities of the nature and extent of tax losses acquired by other clients of the promoter in this shelter can be very important as well.

In the typical case, the transaction fails both prongs of the economic substance analysis. The following facts underscore a lack of a legitimate potential or realistic possibility for a pre-tax profit (i.e objective prong): First, the taxpayer's profit potential from the aggregate foreign currency options is severely limited by the offsetting nature of the respective contracts. Although not a traditional straddle, the option contracts create substantially offsetting positions whereby any gain in one contract is offset in another contract. Second, the profit, if any, would be derived from the contractual provision that required a payment equal to twice the premium amount to the holder if the strike price was at or above a stated amount on the exercise date. Third, the net premium paid to enter the option contracts is a mere 1.75% of the actual loss claimed. Fourth, any potential profit realized would be further reduced by significant up-front transaction costs. The fees paid to the promoter were 5% for a capital loss or 6% for any ordinary loss desired. Fifth, the only true profit potential comes from the additional hedge fund investment that represents a distinct investment separate from the foreign currency scheme. This "real" investment, which was a prerequisite to obtaining the desired loss, provides the trappings of legitimacy and creates the illusion of profit when aggregated with the tax shelter investment. These facts persuasively demonstrate the lack of any realistic potential for pre-tax profit from the foreign currency strategy.

The transaction also fails the subjective economic substance prong. Typically, the taxpayer has significant taxable income (either capital gain income or ordinary income) unrelated to the transaction. Through participation in this transaction, the taxpayer is able to choose the character and amount of the loss needed to offset the unrelated income. The close connection between the taxable income being sheltered and the claimed loss suggests that the taxpayer did not enter into this transaction for a business purpose. As the Tenth Circuit has recognized, "correlation of losses to tax needs coupled with a general indifference to, or absence of, economic profits may reflect a lack of economic substance." Keeler v. Commissioner, 243 F.3d 1212, 1218 (10th Cir. 2001), citing Freytag v. Commissioner, 89 T.C. 849, 877-878 (1987). Here, the taxpayer does not have a substantial non-tax purpose for entering into the structured transaction other than the creation of an artificial tax loss.

If the revenue agent, after consultation with Financial Products specialist and/or economist, determines that it is appropriate to assert economic substance with respect to a specific transaction, consideration must be given to possible appellate venue. As discussed herein, various circuits apply different standards in determining whether a transaction lacks economic substance. Prior to asserting economic substance, the examiner should consult with local Counsel to determine the appropriate standard in their jurisdiction.

In cases where a taxpayer who invested in the transaction is unable to establish that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position and (2) that the taxpayer has a substantial non-tax purposes for entering into such transaction and the transaction is a

reasonable means of accomplishing such purpose the tax benefits, fees or expenses, related thereto, may be disallowed.

6. The taxpayer is not entitled to an ordinary loss under I.R.C. § 988.

I.R.C. §§ 985-989, which were enacted as part of the Tax Reform Act of 1986, set forth a comprehensive set of rules for the treatment of foreign currency transactions. In general, I.R.C. § 988(a)(1)(A) provides that foreign currency gain or loss attributable to an I.R.C. § 988 transaction is computed separately and treated as ordinary income or loss. The I.R.C. § 988 foreign currency transaction rules generally apply to forward contracts, futures contracts, options contracts and similar financial instruments.

The legislative history of I.R.C. §§ 985-989 suggests a consistent concern about tax motivated transactions. The Senate Finance Committee Report accompanying the Tax Reform Act of 1986 stated that one of the two reasons I.R.C. §§ 985-989 were enacted was prior law provided opportunities for tax motivated transactions. S. Rep. No. 313., 99th Cong., 2d Sess. 450 (1986). Accordingly, in enacting I.R.C. §§ 985-989, Congress granted broad authority for the Service to promulgate regulations "as may be necessary or appropriate to carry out the purposes of [I.R.C. §§ 985-989]. . . ." I.R.C. § 989(c). The legislative history to the TAMRA, in discussing the law prior to the enactment of TAMRA, stated that "[t]he Secretary has general authority to provide the regulations necessary or appropriate to carry out the purposes of new subpart J. For example, the Secretary may prescribe regulations appropriately recharacterizing transactions to harmonize the general realization and recognition provisions of the Code with the policies of § 988." H.R. Rep. No. 795, 100th Cong., 2d Sess. 296 (1988); S. Rep. No. 445, 100th Cong., 2d Sess. 311 (1988) (containing identical language).

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

In this case, the transaction at issue may be recharacterized in accordance with its substance so that the taxpayer is required to take into account gain as well as the economically corresponding loss under Treas. Reg. § 1.988-2(f). For purposes of I.R.C. § 988, the Service may adjust the timing of the transaction at issue consistently with its

substance and require the taxpayer to recognize gain upon the transfer of the minor contract to the charity on the date of such transfer. The taxpayer's ordinary loss as reported on its return does not reflect the substance of the transaction because the Investor is not economically exposed to fluctuations in the values of the foreign currency positions. The claimed loss is not the result of exposure to exchange rate fluctuations, but rather of differences in timing of recognition of economically offsetting gain and loss positions in an engineered transaction. Accordingly, under Treas. Reg. § 1.988-2(f), the taxpayer is required to take both gain and loss into account consistently.

Alternatively, the loss may be excluded from I.R.C. § 988 under Treas. Reg. § 1.988-1(a)(11) because the reported loss is due to the different reporting methods of the major and minor contracts and does not reflect changes in foreign currency exchange rates. Excluding the transaction from the provisions of I.R.C. § 988 under this alternative approach, however, would result in capital loss treatment. Barnes Group v. United States, 697 F. Supp 591 (D. Conn. 1988).

7. The 20 percent accuracy-related penalty under I.R.C. § 6662 should be asserted against a taxpayer entering into this transaction unless the taxpayer is able to establish reasonable cause and good faith under I.R.C. § 6664(c)(1) and applicable regulations.

I.R.C. § 6662[4] imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations and (2) any substantial understatement of income tax. Treas. Reg. § 1.6662- 2(c) provides that there is no stacking of the accuracy-related penalty components. Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20 percent (40 percent for gross valuation misstatements), even if that portion of the underpayment is attributable to more than one type of misconduct. See D.H.L. Corp. v. Commissioner, T.C. Memo. 1998-461, aff'd in part and rev'd on other grounds, remanded by 285 F.3d 1210 (9th Cir. 2002).

In order to facilitate the examiner's review of the relevant facts and circumstances associated with application of the I.R.C. § 6662 penalty, this paper first provides a general overview of the law associated with the penalty where there is (a) negligence or disregard of rules or regulations and (b) any substantial understatement of income tax. After the general overview, some more practical suggestions are offered based on the information that has been reviewed to date – including the above-referenced shelter promotion materials and Shelter Memorandum. Much of the focus in that later discussion is on substantial understatement.

[4] The American Jobs Creation Act of 2004, P.L. 108-357, 118 Stat. 1418 (the "Act"), was enacted on October 22, 2004. The Act created § 6662A, which imposes an accuracy related penalty on understatements with respect to reportable transactions, and amended § 6662. I.R.C. § 6662A and the amendments to § 6662 apply only to tax years ending after October 22, 2004. Thus, this CIP does not discuss § 6662A and references § 6662 before amendment by the Act.

Negligence or Disregard of Rules or Regulations

Negligence under I.R.C. § 6662 includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. See I.R.C. § 6662(c) and Treas. Reg. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967), aff'g 43 T.C. 168 (1964); Neely v. Commissioner, 85 T.C. 934, 947 (1985). Treas. Reg. § 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. A return position that has a reasonable basis as defined in Treas. Reg. § 1.6662-3(b)(3) is not attributable to negligence. Treas. Reg. § 1.6662-3(b)(1).

"Disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. A disregard of rules or regulations is "careless" if the taxpayer does not exercise reasonable diligence in determining the correctness of a position taken on its return that is contrary to the rule or regulation. A disregard is "reckless" if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances demonstrating a substantial deviation from the standard of conduct observed by a reasonable person. Additionally, a disregard of the rules and regulations is "intentional" where the taxpayer has knowledge of the rule or regulation that it disregards. Treas. Reg. § 1.6662-3(b)(2).

The term "rules and regulations" includes the provisions of the Internal Revenue Code, temporary or final treasury regulations, and revenue rulings or notices (other than notices of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-3(b)(2). Therefore, if the facts indicate that a taxpayer took a return position contrary to any published notice or revenue ruling, the taxpayer may be subject to the accuracy-related penalty for an underpayment attributable to disregard of rules and regulations, if the return position was taken subsequent to the issuance of the notice or revenue ruling.

The accuracy-related penalty for disregard of rules and regulations will not be imposed on any portion of underpayment due to a position contrary to rules and regulations if: (1) the position is disclosed on a properly completed Form 8275 or Form 8275-R (the latter is used for a position contrary to regulations) and (2) in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation.[5] Treas. Reg. § 1.6662-3(c). This adequate disclosure exception applies only if the taxpayer has a reasonable basis for the position and keeps adequate records to substantiate items correctly. Treas. Reg. § 1.6662-3(c)(1). Moreover, a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the

[5] For returns filed after December 31, 2002, if the position relates to a reportable transaction, adequate disclosure also requires disclosure in accordance with Treas. Reg. § 1.6011-4. Treas. Reg. § 1.6662-3(c)(1).

ruling or notice if the contrary position has a realistic possibility of being sustained on its merits. Treas. Reg. § 1.6662-3(b)(2).

The taxpayer has the ultimate burden of overcoming the presumption that the Service's determination of negligence is correct. Marcello v. Commissioner, 380 F.2d 499, 507 (5th Cir. 1967). With respect to examinations commencing after July 22, 1998, however, the Service must first meet the burden of production with respect to negligence. I.R.C. § 7491(c); Higbee v. Commissioner, 116 T.C. 438, 446 (2002).

Substantial Understatement

A substantial understatement of income tax exists for a taxable year if the amount of the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 for a corporation, other than an S corporation or a personal holding company). I.R.C. § 6662(d)(1). Specific rules apply to the calculation of the understatement when any portion of the understatement arises from an item attributable to a tax shelter. For purposes of I.R.C. § 6662(d)(2)(C), a tax shelter is a partnership or other entity, an investment plan or arrangement, or other plan or arrangement where a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax. I.R.C. § 6662(d)(2)(C)(iii). Because a significant purpose of the Notice 2003-81 transaction is tax avoidance, it is a tax shelter pursuant to I.R.C. § 6662(d)(2)(C). Different rules, however, apply depending upon whether the taxpayer is a corporation or an individual or entity other than a corporation.

In the case of any item of a taxpayer other than a corporation, which is attributable to a tax shelter, understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for such treatment, and (2) the taxpayer reasonably believed that the tax treatment of the item was more likely than not the proper treatment. I.R.C. § 6662(d)(2)(C)(i).[6] The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. Treas. Reg. § 1.6662-4(d)(1). Here, there was no substantial authority for the tax treatment of this transaction. A taxpayer is considered to have reasonably believed that the tax treatment of an item is more likely than not the proper tax treatment if (1) the taxpayer analyzes the pertinent facts and authorities, and based on that analysis reasonably concludes, in good faith, that there is a greater than 50% likelihood that the tax treatment of the item will be upheld if the Service challenges it, or (2) the taxpayer reasonably relies, in good faith, on the opinion of a professional tax advisor, which clearly states (based on the advisor's analysis of the pertinent facts and authorities) that the advisor concludes there is a greater than 50% likelihood the tax treatment of the item will be upheld if the Service challenges it. Treas. Reg. § 1.6662-4(g)(4). However, a taxpayer cannot claim to have reasonably relied in good faith on the opinion of a professional tax advisor if the requirements of Treas. Reg.

[6] It should be noted that the AJCA amendments to I.R.C. § 6662, for tax years ending after October 22, 2004, eliminated reduction of the understatement for all taxpayers if the item is attributable to a tax shelter.

§ 1.6664-4(c)(1) are not met. Treas. Reg. § 1.6662-4(g)(4)(ii). (As a practical matter, the requirement that the opinion take into account the particular motivations and circumstances of the taxpayer makes reliance on a "canned" opinion inherently questionable.) This is discussed further under "Reasonable Cause Exception" below.

If the item is attributable to a tax shelter and the taxpayer is a corporation, the understatement cannot be reduced.[7] I.R.C. § 6662(d)(2)(C)(ii). Therefore, if a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy related penalty applies to the underpayment arising from the understatement unless the reasonable cause and good faith exception applies.

Reasonable Cause Exception

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

The determination of whether the taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all relevant facts and circumstances. See Treas. Reg. § 1.6664-4(b)(1) and Treas. Reg. § 1.6664-4(f)(1). All relevant facts, including the nature of the tax investment, the complexity of the tax issues, issues of independence of a tax advisor, the competence of a tax advisor, the sophistication of the taxpayer, and the quality of an opinion, must be developed to determine whether the taxpayer was reasonable and acted in good faith.

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

Circumstances that may suggest reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the facts, including the experience, knowledge, sophistication and education of the taxpayer. Treas. Reg. § 1.6664-4(b)(1). The taxpayer's mental and physical condition, as well as sophistication with respect to the tax laws, at the time the return was filed, are relevant in deciding whether the taxpayer acted with reasonable cause. See Kees v. Commissioner, T.C. Memo. 1999-41. If the taxpayer is misguided, unsophisticated in tax law, and acts in good faith, a penalty is not warranted. See Collins v. Commissioner, 857 F.2d 1383,

[7] See above note for changes made by the AJCA.

1386 (9th Cir. 1988); cf. Spears v. Commissioner, T.C. Memo. 1996-341, aff'd, 98-1 USTC ¶ 50,108 (2d Cir. 1997)[Court was unconvinced by the claim of highly sophisticated, able, and successful investors that they acted reasonably in failing to inquire about their investment and simply relying on offering circulars and accountant, despite warnings in offering materials and explanations by accountant about limitations of accountant's investigation].

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

The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. See Treas. Reg. § 1.6664-4(c)(1)(ii).

In Long Term Capital Holdings v. United States, 330 F. Supp.2d 122 (D. Conn. 2004), the court concluded that a legal opinion did not provide a taxpayer with reasonable cause where (1) the taxpayer did not receive the written opinion prior to filing its tax return, and the record did not establish the taxpayer's receipt of an earlier oral opinion upon which it would have been reasonable to rely; (2) the opinion was based upon unreasonable assumptions; (3) the opinion did not adequately analyze the applicable law; and (4) the taxpayer's partners did not adequately review the opinion to determine whether it would be reasonable to rely on it. In addition, the court concluded that the taxpayer's lack of good faith was evidenced by its decision to attempt to conceal the losses reported from the transaction by netting them against gains on its return.

Where a tax benefit depends on nontax factors, the taxpayer has a duty to investigate the underlying factors rather than simply relying on statements of another person, such as a promoter. See Novinger v. Commissioner, T.C. Memo. 1991-289. Further, if the tax advisor is not versed in these nontax matters, mere reliance on the tax advisor does not suffice. See Addington v. United States, 205 F.3d 54, 58 (2d Cir. 2000); Collins v. Commissioner, 857 F.2d 1383, 1386 (9th Cir. 1988) Freytag v. Commissioner, 89 T.C. 849, 888 (1987), aff'd,904 F.2d 1011 (5th Cir. 1990).

Although a professional tax advisor's lack of independence is not alone a basis for rejecting a taxpayer's claim of reasonable cause and good faith, the fact that a taxpayer knew or should have known of the advisor's lack of independence is strong evidence that the taxpayer may not have relied in good faith upon the advisor's opinion. See

Neonatology Associates, P.A. v. Commissioner, 115 T.C. 43, 98 (2001), aff'd 299 F.3d 221 (3rd Cir. 2002) ["Reliance may be unreasonable when it is placed upon insiders, promoters, or their offering materials, or when the person relied upon has an inherent conflict of interest that the taxpayer knew or should have known about"]; Goldman v. Commissioner, 39 F.3d 402, 408 (2d Cir. 1994) aff'g T.C. Memo. 1993-480 ["Appellants cannot reasonably rely for professional advice on someone they know to be burdened with an inherent conflict of interest"]; Marine v. Commissioner, 92 T.C. 958, 992-93 (1989), aff'd without published opinion, 921 F.2d 280 (9th Cir. 1991). Such reliance is especially unreasonable when the advice would seem to a reasonable person to be "too good to be true." Pasternak v. Commissioner, 990 F.2d 893, 903 (6th Cir. 1993), aff'g Donahue v. Commissioner, T.C. Memo. 1991-181; Gale v. Commissioner, T.C. Memo. 2002-54; Elliot v. Commissioner, 90 T.C. 960, 974 (1988), aff'd without published opinion, 899 F.2d 18 (9th Cir. 1990); Treas. Reg. § 1.6662-3(b)(2).

Similarly, the fact that a taxpayer consulted an independent tax advisor is not, standing alone, conclusive evidence of reasonable cause and good faith if additional facts suggest that the advice is not dependable. Edwards v. Commissioner, T.C. Memo. 2002-169; Spears v. Commissioner, T.C. Memo. 1996-341, aff'd, 98-1 USTC ¶ 50,108 (2d Cir. 1997). For example, a taxpayer may not rely on an independent tax adviser if the taxpayer knew or should have known that the tax adviser lacked sufficient expertise, the taxpayer did not provide the advisor with all necessary information, or the information the advisor was provided was not accurate." Baldwin v. Commissioner, T.C. Memo. 2002- 162; Spears v. Commissioner, T.C. Memo. 1996-341, aff'd, 98-1 USTC ¶ 50,108 (2d Cir. 1997).

Observations Regarding Application of Penalty to This Shelter

When it appears that imposing the accuracy-related penalty is warranted, the examiner needs to carefully evaluate the application of the penalty for each taxpayer that is audited. This review is made somewhat easier by the fact that taxpayers must satisfy more stringent standards to avoid application of the penalty where the substantial understatement is in connection with a tax shelter transaction. From a practical standpoint, it will be critical for the examiner to focus upon whether the taxpayer based its return position on a more likely than not legal opinion of a professional tax advisor that considered all pertinent facts and lines of legal authority. Based on the review of the limited materials gathered to date in connection with this shelter transaction, it may be quite difficult for taxpayers to show that they satisfied that standard.

As an initial matter, the examiner should determine whether the taxpayer obtained or relied upon a signed and dated legal opinion that unambiguously concludes that the taxpayer's return positions were more likely than not to be sustained if challenged. If the taxpayer has not reasonably relied on such an opinion, then the accuracy-related penalty should be asserted.

Moreover, while all facts would still have to be considered, the accuracy-related penalty should also apply if the taxpayer simply relied on a "canned" legal opinion that does not address that taxpayer's particular circumstances. Almost by definition, such a "canned" opinion could not be reasonably relied upon because it would not address the taxpayer's particular motivations and other pertinent circumstances.

Even if the taxpayer could have reasonably relied on a "canned" legal opinion or one that is directed to the taxpayer, it will be necessary to evaluate whether the opinion took into account all pertinent facts and lines of legal authority. If the draft Shelter Memorandum is a good barometer of the quality of the opinions, if any, provided to taxpayers, the examiner may find that highly pertinent facts were overlooked or misstated. For instance, it is plainly troubling that the draft Shelter Memorandum reached its conclusions regarding section 1092 by assuming that the assigned foreign currency options were not substantially offsetting positions even though separate promotional documents clearly tout the positions as being almost completely offsetting. Moreover, the legal memorandum virtually ignores all discussion of the economics and legal effects of the assignments.

In addition, it will be critical to examine whether the legal opinion addressed all relevant lines of legal authority. As a guide, the examiner should determine if each of the legal issues raised in this CIP were meaningfully considered. The draft Shelter Memorandum was clearly deficient in that regard. For instance, the legal memorandum failed to consider any authority that addresses the tax accounting for options and failed to consider whether the form of assignment caused gain or loss to be recognized under the open transaction doctrine. Though section 988 was considered, the draft memorandum also failed to consider the anti-abuse rules of Treas. Reg. 1.988-2(f).

8. **The agent examining the taxable entity should forward all information gathered about the involvement of the charity to the Exempt Organizations Division of TEGE through the process established by the Notice 2003-81 Issue Management Team.**

Through IDRs and otherwise, the agent examining a taxable entity that entered into one of these transactions will obtain information about the involvement of the charity. In all cases, the agent should forward that information to the Exempt Organizations Division of TEGE through the process established by the Notice 2003-81 Issue Management Team. Examiners should refer to the Notice 2003-81 toolkit for the most current EO contact information, including contact person, address, phone and fax numbers. Information provided by the examiners to Exempt Organizations will be helpful in alerting Examination and Determination Agents so they may identify issues and take appropriate actions.

Exempt Organizations will need to exercise discretion in determining how to proceed with the information that it receives because the nature of the charity's involvement in these transactions may vary. In some cases, a "charity" may have been created by the promoter or someone affiliated with the promoter specifically to facilitate these

transactions. The custom-made charity may purport to engage in appropriate charitable activities, but evidence could show substantial and/or repeated involvement as the accommodation party in the transaction. Other cases may involve charities that are well-established in their appropriate charitable endeavors but that appear as accommodation parties in these or other abusive tax transactions. Their involvement may appear on the books simply as a donation, as a net donation from offsetting options or property, or as part of an investment portfolio.

The Service will apply the full array of enforcement tools to those entities whose focus is on accommodating abusive tax transactions. Playing that role does not further a charitable or other tax-exempt purpose. If this role is apparent in the application process for exemption, the Service will not recognize the entity as exempt. If the Service discovers this abusive behavior after having already recognized the entity as exempt, the Service will move to revoke the entity's exemption, possibly back to its inception.

Where the Service learns that an otherwise compliant charity has become involved in an abusive transaction as an accommodating party, whether booked as a donation, fee, investment, or otherwise, the charity may expect to be contacted by the Service. The charity may be requested to provide the details of its involvement, information about the transaction and other parties, etc. Depending on the circumstances, this contact may be made by the Exempt Organizations Division as a compliance check with respect to the Form 990 or other return, or as part of an inquiry into the charity's own taxation and exemption status or other associated tax issues. In the alternative, it may arise as a third-party request for information relating to the examination of a promoter or taxable party. Prior to any contact being made to charity, coordination must first be made with the Exempt Organizations Division. While these transactions, at a minimum, raise questions about an organization's governance, if significant levels or types of involvement come to light, the Service will take the tax-exempt entity's involvement into account in determining whether to continue to recognize the entity's exemption or to apply an appropriate tax.