APPEALS
COORDINATED ISSUE PAPER
SETTLEMENT GUIDELINES

ISSUE: IRC § 351 Contingent Liability
Capital Loss Transactions

COORDINATOR: Judith A. Witteman

TELEPHONE: (504) 558-3110

UIL NO: 9300.17-00

FACTUAL/LEGAL ISSUE: Legal and Factual

APPROVED:

/s/ Thomas C. Lillie	July 14, 2004
for **DIRECTOR TECHNICAL GUIDANCE**	**DATE**
/s/ L.P. Mahler	July 14, 2004
DIRECTOR, TECHNICAL SERVICES	**DATE**

EFFECTIVE DATE: **July 14, 2004**

SETTLEMENT POSITION
IRC § 351 CONTINGENT LIABILITY
CAPITAL LOSS TRANSACTIONS

ISSUE 1

Whether transactions described in Notice 2001-17, 2001-1 C.B. 730, and substantially similar transactions (herein “Contingent Liability Transactions”) satisfy the technical requirements of I. R. C. § 351.[1]

ISSUE 2

In cases where a Contingent Liability Transaction took place after October 19, 1999, whether I. R. C. § 358(h) applies.

ISSUE 3

Whether the contingent liability is a liability that gives rise to a deduction within the meaning of I. R. C. § 357(c)(3) and whether the taxpayer’s basis in its stock is determined by reference to I. R. C. § 358(d)(1) or I. R. C. § 358(d)(2).

ISSUE 4

Whether the liability assumption should be treated as money received under I. R. C. § 357(b).

ISSUE 5

Whether the liability assumption should be treated as a promise to pay, rather than as a legal obligation, such that the promise constitutes “other property” within the meaning of I. R. C. § 358(a).

ISSUE 6

Whether preferred stock issued in connection with the I. R. C. § 351 transaction is non-qualified preferred stock within the meaning of § 351(g), or the stock sale may be otherwise disregarded for tax purposes.

[1] All references are to the Internal Revenue Code of 1986, as amended.

ISSUE 7

Whether the stock loss should be disallowed or re-characterized under applicable judicial principles, including lack of economic substance or step transaction.

ISSUE 8

Whether the liability assumption has been properly valued.

ISSUE 9

Whether the transferor or the transferee is entitled to a deduction (or other tax benefit) arising from the subsequent payment of the contingent liability (and, with respect to the transferor, whether it or any consolidated group of which it is a member can avail itself of the tax benefits associated with both the loss claimed on the stock sale and the deduction claimed for payments in satisfaction of the transferred liability).

ISSUE 10

Whether the Service should assert the negligence or disregard of rules and regulations, the substantial understatement of income tax, or the substantial valuation misstatement portions of I. R. C. § 6662 against a taxpayer for engaging in a Contingent Liability Transaction.

OVERVIEW OF COMPLIANCE'S POSITION[2]

The Service announced in Notice 2001-17 that the Contingent Liability Transaction, or substantially similar transactions, are "listed transactions" for the purposes of Treas. Reg. § 1.6011-4T(b)(2).

Compliance has determined that the basis of the stock received in the transaction is either limited to its fair market value or reduced by the amount of the liabilities assumed in the transaction, with the result that the taxpayer recognizes no loss on the sale of the stock.

---

[2] In Notice 2001-17 and Chief Counsel Notice CC-2001-033a, the Service expressed the opinion that the transaction was structured using member securities to avoid the potential application of the duplicated loss rules under Treas. Reg. § 1.1502-20(c)(2)(vi)(A)(1). However, in Rite Aid Corp. v. United States, 255 F.3d 1357 (Fed. Cir. 2001), the Federal Circuit held that the duplicated loss component of the LDR represents an invalid exercise of regulatory authority. In view of this decision and the Service's interim guidance in Notice 2002-11, 2002-1 C.B. 526, Compliance will not argue that the duplicated loss rules apply in Contingent Liability Transactions at this time.

There may be differences among cases with respect to the structuring of the transaction, the type of contingent liability assumed, the purported business purpose and the extent to which such business purpose was executed. However, it is Compliance's position that any business purpose is far outweighed by the taxpayer's interest in generating deductible losses.

OVERVIEW OF TAXPAYERS' POSITION

Taxpayers generally argue that they meet the requisite business purpose test of I. R. C. § 357(b) and, further, the liabilities come under the scope of I. R. C. § 357(c)(3), such that basis in the stock received is not reduced by the amount of the liabilities assumed.

FACTS

The transactions in question generally involve a transfer that purportedly complies with I. R. C. § 351 of high basis assets from a transferor corporation ("taxpayer") to a transferee corporation ("transferee") controlled by the transferor. The assets are transferred in exchange for stock of the transferee and the transferee's assumption of a liability of the transferor, which has not yet been taken into account for tax purposes, and that would be deductible by the transferor when paid.

The asset transferred by the taxpayer to the transferee has a basis that approximately equals its value. The asset will typically be cash or a security. In the case of a consolidated group, the asset will typically be a security issued by a member of the group (or other property that is used to acquire a member security).

The liability assumed by the transferee subsidiary is only slightly less than the basis/fair market value of the asset. The liabilities are most often for environmental remediation, contingent tort liabilities, or employee medical or retirement benefits. In some cases, such as those involving tort or environmental liabilities, the taxpayer may face legal impediments to the transfer of the liabilities. In some cases, the liability assumed may be a mere promise to pay a future liability that has not yet been incurred.

Often the taxpayer will re-capitalize a dormant subsidiary to effect the Contingent Liability Transaction by authorizing a new class of common or preferred stock. The purported business purpose of the dormant subsidiary is redefined as risk or liability management. Amended or restated certificates or articles of incorporation may be filed in the state of incorporation. The taxpayer and the transferee (purported risk or liability management company ("LMC")) may enter into a separate agreement relating to the assumption of the liability. The agreement may cover all or a portion of existing and/or future liabilities. The extent to which the transferee liability management company was actively engaged in a business activity varies among the cases. Often, the taxpayer and the transferee enter into other ancillary agreements such as support or administrative agreements, which minimize the business consequences of the restructuring.

Shortly after the exchange, and as part of the overall plan, the transferor sells the stock received in the exchange for its fair market value and claims a loss in an amount approximating the present value of the liability assumed by the transferee. The effect is to accelerate the tax benefit of the deduction of the liabilities assumed by the transferee. In the case of a transaction involving members of an affiliated group that has elected to file a consolidated return, the transaction may be structured to avoid deconsolidation so that, when the transferee pays the liability, the group may claim that it is entitled to a deduction for the payments, thus duplicating the tax benefit within the group. In many cases, the LMC has deconsolidated at the time of the transaction, but has intentions of reconsolidating within five years.

The purchaser of the stock may be an employee, a consultant or other entity related to the LMC. The purchaser may also be an accommodating party such as a bank or insurance company who may have an ongoing business relationship with the transferor. Frequently, the stock purchase agreements contain put and call options, or other mechanisms minimizing the risk to the purchaser. In some Contingent Liability Transactions the outside purchaser of the stock has a guaranteed return on its investment.

The entire Contingent Liability Transaction takes place within a short period of time, typically several weeks or months.

The transaction is purported to qualify as an exchange under I. R. C. § 351, with the intent that the basis of the stock that the transferor receives from the transferee will be determined by the basis of the transferred asset. The liability is purported to be a liability described in I. R. C. § 357(c)(3)(A) because the assumption of such a liability does not reduce the basis of the stock received per I. R. C. § 358(d)(2). Taxpayers argue the interplay of I. R. C. § 351, coupled with the exclusion of the contingent liability purportedly under I. R. C. § 357(c), results in the creation of the high-basis, low-fair market value stock.

Taxpayers assert various business purposes for entering into the Contingent Liability Transactions such as centralizing or reducing liabilities. Cases differ regarding the strength of the taxpayer's business purpose arguments.

LAW AND ANALYSIS

ISSUE 1

Compliance's Position

Compliance's Position is that the Contingent Liability Transaction must satisfy the technical requirements of I. R. C. § 351,[3] including the control requirement of I.R.C. § 368(c), and the requirement that the transferee is not an investment company within the meaning of I. R. C. § 351(e). Compliance notes that most Contingent Liability Transactions will meet the statutory requirements of I. R. C. § 351. Compliance will not argue that the transaction does not satisfy I. R. C. § 351 on the grounds that it lacks a business purpose; instead, the lack of a business purpose will be raised in support of the arguments discussed in Issue 4 and Issue 7.

Taxpayers' Position

Taxpayers argue that they meet the technical requirements of I. R. C. § 351.

Discussion

I. R. C. § 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by a person solely in exchange for stock in such corporation and immediately after the exchange such person is in control of the corporation.

I. R. C. § 351(b) provides that if I. R. C. § 351(a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under I. R. C. § 351(a), other property or money ("boot"), then gain (if any) to such recipient shall be recognized, but not in excess of the amount of boot received, and no loss to such recipient shall be recognized.

The first step of the Contingent Liability Transaction is a purported I. R. C. § 351 exchange. Therefore, the threshold inquiry is whether the transaction in which the transferee stock is received satisfies the technical requirements of I. R. C. § 351,

---

[3] I. R. C. § 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for stock, and, immediately after the exchange, the transferor or transferors are in control of the corporation. "Control" is defined in I. R. C. § 368(c), which provides that control requires ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. For this purpose, ownership must be direct, not by attribution, unless the transferor is a member of a consolidated group (in which case it may be treated as owning stock owned by members of the same group, see Treas. Reg. § 1.1502-34). See Rev. Rul. 56-613, 1956-2 C.B. 212; Rev. Rul. 78-130, 1978-1 C.B. 114.

including the control requirements of I. R. C. § 368(c) and the requirement that the transferee is not an investment company within the meaning of I. R. C. § 351(e).

If the exchange fails to qualify under I. R. C. § 351, it is an I. R. C. § 1001 exchange; the basis of the transferor's stock is its fair market value, and there is no loss on the subsequent sale.

ISSUE 2

Compliance's Position

Compliance argues that Contingent Liability Transactions that took place after October 18, 1999 are subject to I. R. C. § 358(h), thus, even if the stock would otherwise be treated as having a basis equal to the transferor's basis in the property transferred, the stock basis will be reduced by the amount of the liability assumption (but not below fair market value[4]).

Compliance further argues that while guidance has not been issued on the application of I. R. C. § 358(h) in cases where the liabilities relate to discontinued businesses, this provision was intended to apply to Contingent Liability Transactions as they represent the very abuse at which the provision was intended.

Compliance further argues that in determining whether I. R. C. § 358(h) applies to a particular transaction, the taxpayer is obligated to respect its own form of the transaction, including the date of the transfer of the liabilities for book purposes.

Taxpayers' Position

In some cases, e.g., those involving the transfer of obligations of an inactive corporation, taxpayers may claim that the transfer is within the scope of I. R. C. § 358(h)(2)(A) or I. R. C. § 358(h)(2)(B), since the transfer involves all that remains of a once active business, which may not have any remaining associated assets at the time of transfer.

Taxpayers also raise factual issues in other cases as to whether the transfer took place after the effective date of I. R. C. § 358(h).

[4] Where the transferor and transferee are members of a consolidated group subsequent to the purported exchange, Compliance argues no further adjustment is made to the stock basis when the transferee makes a payment with respect to the assumed liability. See Treas. Reg. §1.1502-32(a)(2) (subsidiary stock basis "must not be adjusted under this section and other rules of law in a manner that has the effect of duplicating an adjustment").

Discussion

I. R. C. § 358(h) is effective for transfers after October 18, 1999. I. R. C. § 358(h)(1) provides that, if, in an I. R. C. § 351 exchange, the basis of the stock received exceeds its fair market value, then such basis shall be reduced (but not below fair market value) by the amount of any liability assumed in exchange for the stock (unless the assumption was treated as money received by the transferor under I. R. C. § 358(d)(1)).

I. R. C. § 358(h)(2)(A) excludes the assumption of any liability that is assumed in connection with the transfer of the trade or business with which the liability is associated; I. R. C. § 358(h)(2)(B) provides a similar exclusion for the assumption of a liability in connection with the transfer of substantially all of the assets with which the liability is associated.

Contingent Liability Transactions where the I. R. C. § 351 exchange occurred after October 18, 1999 are subject to I. R. C. § 358(h). Thus, in cases where I. R. C. § 358(h) applies, the stock basis will be reduced by the amount of the liability assumption (but not below the fair market value of the stock). This would eliminate the capital loss.

The legislative history of I. R. C. § 358(h) states:

> The exception for transfers of a trade or business, or of substantially all of the assets, with which a liability is associated, are intended to obviate the need for valuation or basis reduction in such cases. The exceptions are not intended to apply to situations involving the selective transfer of assets that may bear some relationship to the liability, but that do not represent the full scope of the trade or business, (or substantially all the assets) with which the liability is associated.

A corporation that merely has a liability from a once active business, or a discontinued business operation, would not meet the exception of I. R. C. § 358(h)(2)(A), since the full scope of the trade or business associated with the liability, i.e., the trade or business that generated the liability, is effectively no longer in existence. Substantially all of the assets with which an assumed liability is associated are not transferred where the assets have been previously sold or distributed in liquidation. Thus, I. R. C. § 358(h)(2)(B) would not apply.

A determination of whether the transaction falls under I. R. C. § 358(h) based on the date of the exchange is a question of fact. It is well settled that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not. See Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974), citing Higgins v. Smith, 308 U.S. 473, 477 (1940); Old Mission Portland Cement Co. v. Helvering, 293 U.S. 289, 293 (1934); Gregory v. Helvering, 293 U.S. 465, 469 (1935).

ISSUE 3

Compliance's Position

Compliance argues, assuming the transaction qualifies as an I. R. C. § 351 exchange, that the taxpayer's basis in the transferee stock received is equal to the basis in the property transferred, reduced by the liabilities assumed in the exchange, per I. R. C. §§ 358(a) and (d)(1).

It is Compliance's position that the legislative history of I. R. C. § 357(c)(3) demonstrates that it applies only to liabilities the payment of which would have been deductible by the transferor, but no longer are as a result of the assumption (e.g., because the liabilities are deductible by the transferee). Stated otherwise, § 357(c)(3)(A) does not apply to liabilities the payment of which, subsequent to the assumption, continues to give rise to a deduction by the transferor (and not the transferee).

In the Contingent Liability Transaction, payment of the assumed liabilities continues to give rise to a deduction by the transferor, and therefore the assumption is not within the scope of I. R. C. § 357(c)(3). Either by reference to I. R. C. §§ 162 or 482, the assumed liabilities are for the benefit of the transferor's (or another member of the consolidated group's) business, not the transferee's business, and are therefore not deductible by the transferee, since the liabilities have not been transferred along with its associated assets. Rather, the payment of the assumed liabilities will give rise to a deduction by the transferor. Accordingly, I. R. C. § 358(d)(1) requires the reduction of stock basis by the amount of the assumed liability.

If the liability is not within the scope of I. R. C. § 357(c)(3), then I. R. C. § 358(d)(2) does not prevent the I. R. C. § 358(d)(1) basis reduction of the stock received by the amount of the liability assumed. Therefore, no loss is generated upon the sale of the stock.

Taxpayers' Position

Taxpayers claim that, based on the plain language of the statute, because the liability is one that will give rise to a deduction at some time in the future, it is a liability described in I. R. C. § 357(c)(3), and that, therefore, I. R. C. § 358(d)(2) prevents the basis reduction required under I. R. C. § 358(d)(1). This creates a high basis for the stock that, when subsequently sold at its low fair market value, generates a capital loss. Taxpayers rely on Revenue Ruling 95-74, 1995-2 C.B. 36, to support their argument.

Discussion

I. R. C. § 357 provides for the tax treatment of an assumption of liabilities in an I. R. C. § 351 exchange. The general rule under I. R. C. § 357(a) is that the transferee's assumption of a liability, or its acquisition of property subject to a liability, is not treated as money or other property received ("boot"). Thus, I. R. C. § 351(b) does not force the recognition of gain by the transferor on the amount of the liabilities assumed.

In tandem, I. R. C. § 358(a)(1) addresses basis, providing a general rule that, in the case of an I. R. C. § 351 exchange, the basis of stock of the transferee corporation received by the transferor is the same as that of the property exchanged, decreased by the amount of money received by the taxpayer, and increased by the amount of gain to the taxpayer which was recognized on the exchange.

I. R. C. § 358(d)(1) provides that where, as part of the consideration to the taxpayer, another party to the exchange assumes a liability of the taxpayer or acquires from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of I. R. C. § 358, be treated as money received by the taxpayer on the exchange.

Thus, the general rule, assuming the transaction otherwise qualifies as an I. R. C. § 351 exchange, is that the taxpayer's basis in the transferee stock received is equal to the basis in the property transferred, reduced by the liabilities assumed in the exchange, per I. R. C. §§ 358(a) and (d)(1).

I. R. C. § 357 contains two exceptions to the general rule of I. R. C. § 357(a). The first, found at I. R. C. § 357(b), is discussed in Issue 4 below. The second exception is found at I. R. C. § 357(c), and addresses the case of liabilities in excess of basis. I. R. C. § 357(c)(1) provides that, in an I. R. C. § 351 exchange, if the sum of the amount of the liabilities assumed exceeds the total adjusted basis of the property transferred, then the excess of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, over the total adjusted basis of the property transferred is gain.

I. R. C. § 357(c)(3)(A)[5] provides an exception to the exception in I. R. C.

[5] 357(c)(3) Certain liabilities excluded.--

357(c)(3)(A) In general.--If a taxpayer transfers, in an exchange to which section 351 applies, a liability the payment of which either--

357(c)(3)(A)(i) would give rise to a deduction, or

§ 357(c)(1). If a taxpayer transfers a liability in an I. R. C. § 351 exchange, the payment of which would "give rise to a deduction," then, for purposes of I. R. C. § 357(c)(1), the amount of the liability is excluded in determining the amount of liabilities assumed or to which the property transferred is subject. Thus, where the taxpayer assumes a liability in excess of basis, and I. R. C. § 357(c)(3) applies, no gain is recognized on the excess liability.

Further, I. R. C. § 358(d)(2) provides that I. R. C. § 358(d)(1) shall not apply to the amount of any liability excluded under I. R. C. § 357(c)(3). Therefore, if the excess liability is within the scope of I. R. C. § 357(c)(3), then I. R. C. § 358(d)(2) prevents the application of I. R. C. § 358(d)(1), so the basis of the stock received is not reduced by the amount of the liability assumed.

The liabilities involved in Contingent Liability Transactions do not fall under the scope of I. R. C. § 357(c)(3) because the application of that section is limited to liabilities "the payment of which…would give rise to a deduction" to the transferor, but no longer are as a result of the assumption (e.g., because the liabilities are deductible by the transferee). Although not explicit in the statutory language, this limitation on the scope of liabilities subject to I. R. C. § 357(c)(3) is clear from the legislative intent, as set forth in the legislative history, in which Congress states:

> Liabilities excluded under this provision are those liabilities the payment of which by the transferor would give rise to a deduction and those liabilities the payment with respect to which would be described in section 736(a) of the Code.
>
> In general, liabilities the payment of which would give rise to a deduction include trade accounts payable, and other liabilities (e.g., interest and taxes), which relate to the transferred trade or business. However, such liabilities may be excluded only to the extent payment thereof by the transferor would have given rise to a deduction. A liability would not be excluded under this provision to the extent the liability has already been deducted by the transferor. In addition, a liability would not be excluded under this provision to the extent that the incurrence thereof resulted in the creation of, or increase in, the basis of any property.[6]

357(c)(3)(A)(ii) would be described in section 736(a) ,

then, for purposes of paragraph (1), the amount of such liability shall be excluded in determining the amount of liabilities assumed.

357(c)(3)(B) Exception.--Subparagraph (A) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property.

[6] S. Rep. No. 96-498 (1979), 1980-1 C.B. 517, 546. Also see S. Rep. No. 95-1263 (1978) and Pub. L. 95-600 (General Explanation of the Revenue Act of 1978).

The legislative history further expressly states that it is codifying the approach taken in Focht v. Commissioner, 68 T.C. 223 (1977). Focht likewise set forth the rule that:

> The assumption of a deductible obligation of a cash method taxpayer is a non-realizable event because it is improper to treat the assumed liability as income to the transferor and deny him the tax benefit for its satisfaction.[[7]] However, a cash basis taxpayer transferring a nondeductible liability realizes gain irrespective of whether he enjoyed a prior tax benefit, as actual payment would generate no additional tax deduction.[8] [Emphasis added].

Thus, I. R. C. § 357(c)(3) was intended to prevent the taxation of phantom gain under I. R. C. § 357(c)(1) due to the assumption of a liability that, if paid by the transferor prior to the exchange, would have given rise to a deduction to the transferor, but as a result of the assumption, no longer will give rise to a deduction to the transferor. I. R. C. § 358(d)(2), in turn, also prevents the taxation of phantom gain by preventing a decrease in stock basis under I. R. C. 358(d)(1) for liabilities described under I. R. C. § 357(c)(3).

This interpretation is also consistent with the results in Revenue Ruling 80-198, 1980-2 C.B. 113, and Revenue Ruling 80-199, 1980-2 C.B. 122.

In Rev. Rul. 80-199, the taxpayer transferred assets comprising an entire trade or business, and the transaction had a bona fide business purpose. The Service ruled that:

> No gain is realized by (the transferor) on the exchange of property for stock by reason of section 357(c) of the Code because the accounts payable assumed by the corporation would have been deductible by (the transferor) as ordinary and necessary business expenses under §162 in the taxable year if paid by (the transferor) prior to the exchange.

Similarly, in Rev. Rul. 80-198, the taxpayer had a valid business purpose for the transaction, and the transferor transferred all of the assets of an ongoing business, along with the associated liabilities, to a transferee who would continue the business of the transferor. The ruling goes on to detail limitations on its scope, as follows:

---

[7] In contrast, in a Contingent Liability Transaction the transferor remains entitled to the tax benefit for satisfaction of the assumed liability. See the discussion at Issue 9 for situations in which the transferor is, or has been, allowed to claim the stock loss.
[8] While Focht addressed an inequity arising out of the treatment of accounts payable to a cash basis taxpayer, the principle enunciated remains applicable.

> Likewise, it may be appropriate in certain situations to allocate income, deductions, credits, or allowances to the transferor or transferee under § 482 when the timing of the corporation improperly separates income from related expenses. See Rooney v. United States, 305 F.2d 681 (9th Cir. 1962), where a farming operation was incorporated in a transaction described in § 351(a) after the expenses of the crop had been incurred but before the crop had been sold and income realized. The transferor's tax return contained all of the expenses but none of the farming income to which the expenses related. The United States Court of Appeals for the Ninth Circuit held that the expenses could be allocated under § 482 to the corporation, to be matched with the income to which the expenses related. Similar adjustments may be appropriate where some assets, liabilities, or both, are retained by the transferor and such retention results in the income of the transferor, transferee, or both, not being clearly reflected.

In the typical Contingent Liability Transaction, however, the relief afforded under I. R. C. § 357(c)(3) is not necessary because the transferor, not the transferee, is the proper party to claim the deduction arising from the payment of the liability (if otherwise allowable), for the following reasons.

I. R. C. § 162 permits the deduction of a taxpayer's own necessary and ordinary business expenses. Welch v. Helvering, 290 U.S. 111, 113 (1933). It does not permit deduction of expenses paid or incurred for the benefit of another person or entity. Welch, 290 U.S. at 114; see also Deputy v. du Pont, 308 U.S. 488, 494 (1940) (no deduction allowed to an individual for payment of corporate expenses). In a Contingent Liability Transaction, payment of the liability is not deductible by the transferee under I. R. C. § 162 because the assets and/or trade or business associated with the liability continue to be owned and/or operated by the transferor (i.e., it is an expense incurred for the benefit of the transferor).

Absent the exception provided by Rev. Rul. 95-74 (discussed below), taxpayers in these cases are subject to the rule set forth in Holdcroft Transportation Co. v. Commissioner, 153 F. 2d 323 (8th Cir. 1946). Pursuant to Holdcroft, the assumption of the liability is part of the cost of acquiring the transferred asset and so the payment of the liability does not give rise to a deductible expense for the transferee.[9] See also, Smith v. Commissioner, 418 F.2d 589, 596 (5th Cir. 1969); Buten v. Commissioner, T.C. Memo 1972-44. In such a case, the deduction upon payment of the liability should accrue to the transferor, in which case there is no need to preserve the loss in the stock

[9] Note that the transferee's basis in the assets received is determined under section 362; therefore, the later payment of the liability gives rise to no additional basis to the transferee. See Ways and Means Committee Report, H. Rept. No. 855, 76th Congress 1st Sess. (1939), 1939-2 C.B. 518, 519.

basis. See Hood v. Commissioner, 115 T.C. 172, 176 n. 4 (2000) (respondent conceded that because the legal fees were an ordinary and necessary business expense of the shareholder, in the event of a constructive distribution to the shareholder by reason of the corporation's payment of the expense, such payment is deductible by the shareholder); Midwest Stainless Inc. v. Commissioner, T.C. Memo 2000-314 (the Court noted that an identical concession "appears to us to be appropriate").

In the case of Contingent Liability Transactions involving the assumption of employee benefit liabilities, a further restriction is imposed under I. R. C. § 404, which sets forth the provisions relating "to the deduction for contributions of an employer to an employee's trust or annuity plan and compensation under a deferred payment plan." By express operation of the statute, the deduction for such benefits accrues to the employer. I. R. C. §§ 419 and 419A contain similar limitations as to the deductibility of welfare benefit funds. For contributions made in taxable years after December 31, 1985, I. R. C. §§ 419 and 419A limit the deductibility of employer contributions to a welfare benefit fund to the qualified cost for the fund's taxable year ending with or within the employer's taxable year. These sections allow a limited current-year deduction for contributions to fund expenses paid in a subsequent year only if such expenses represent claims incurred but unpaid at the fund's year end, or a reserve for post-retirement medical and life insurance benefits. I. R. C. §§ 419A(c)(1) and (2).

In addition, irrespective of whether the transferor and transferee are members of the same consolidated group, they are generally "owned or controlled directly or indirectly by the same interests," and therefore within the purview of I. R. C. § 482. I. R. C. § 482 provides that "[i]n any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions . . . between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." The Secretary may allocate any item or element affecting taxable income, including basis, per Treas. Reg. §1.482-1(a)(2). Generally, the Commissioner's determinations under I. R. C. § 482 must be sustained absent an abuse of discretion. G.D. Searle and Co. v. Commissioner, 88 T.C. 252, 358 (1988). Accordingly, any deductions claimed by the transferee may, if appropriate, be allocated to the transferor under this section.

Taxpayers argue that, notwithstanding the authorities discussed above, Rev. Rul. 95-74 allows the transferee to deduct the payments made in satisfaction of the contingent liabilities.

In Rev. Rul. 95-74, the Service expanded the scope of the excluded liabilities under I. R. C. § 357(c)(3) to include contingent liabilities in a case because, for bona fide business purposes, the taxpayer transferred substantially all of the assets of a manufacturing business in an I. R. C. § 351 exchange to a new corporation and had no intention to dispose of the stock received in the exchange.

The Service stated that, under the facts of Rev. Rul. 95-74, it would not follow the decision in Holdcroft, 153 F. 2d 323 (8th Cir. 1946). In Holdcroft, the 8th Circuit held that, after a transfer pursuant to the predecessor of I. R. C. § 351, the payments by a transferee corporation were not deductible, even though the transferor partnership would have been entitled to the deductions for payments had the partnership actually made the payments. The court stated generally that the expense of settling liabilities of a predecessor entity did not arise as an operating expense or loss of the business of the transferee but was part of the cost of acquiring the predecessor's property, and the fact that claims were contingent and unliquidated at the time of the acquisition was not of controlling consequence.[10]

Rev. Rul. 95-74 is inapplicable to the typical Contingent Liability Transaction for at least two reasons. First, taxpayers transferring liabilities, whether retirement benefits, workforce liabilities, environmental liabilities, or insurance liabilities, generally do not transfer the related business or assets. Second, taxpayers in these cases generally do not intend to retain the stock received in the exchange. Either of these circumstances removes an exchange from the scope of Rev. Rul. 95-74, causing general tax principles to apply to determine the taxpayer entitled to the deduction arising from the payment of the liability. As discussed above, the transferor remains the taxpayer entitled to claim the deduction arising from the satisfaction of the liability (if otherwise allowable) and so the liability assumption is not within the scope of I. R. C. § 357(c)(3).

Taxpayers may also argue that the enactment of I. R. C. § 358(h) reflects that I. R. C. §§ 357(c)(3) and 358(d)(2) do not apply to the Contingent Liability Transaction. However, it is well settled that "the views of one Congress as to the construction of a statute adopted many years before by another Congress have 'very little, if any, significance.'" United States v. Southwestern Cable Company, 392 U.S. 157, 170 (1968); see also Rainwater v. United States, 356 U.S. 590 (1958), Winn-Dixie Stores, Inc. and Subs. v. Commissioner, 113 T.C. 254 (1999), aff'd 254 F.3d 1313 (11th Cir. 2001) (taxpayer argued the enactment of the 1996 HIPA legislation demonstrated that its deductions for COLI policy loan interest demonstrated that prior law condoned the deductions, but the Tax Court squarely rejected this argument, stating "we are not persuaded that Congress, by enacting and amending section 264 or other related provisions that RESTRICT the deductibility of interest, intended to ALLOW interest deductions under section 163 based on transactions that either lacked economic substance or business purpose.").

---

[10] Note, however, that the transferee's basis in the assets received is determined under § 362; therefore, the later payment of the liability would not give rise to any additional basis to the transferee. See Ways and Means Committee Report, H. Rept. No. 855, 76th Congress 1st Sess. (1939), 1939-2 C. B. 518, 519.

Accordingly, because the liability at issue in the Contingent Liability Transaction is not excluded under I. R. C. § 357(c)(3)(A)(i), I. R. C. § 358(d)(2) is inapplicable, and the general rule of I. R. C. § 358(d)(1) applies to reduce the stock basis by the amount of the liability.

ISSUE 4

Compliance's Position

Compliance argues that the principal purpose of the liability assumption was to facilitate the creation of a high basis, low value stock the disposition of which results in a substantial capital loss, and such purpose is not a bona fide business purpose under I. R. C. § 357(b).

Taxpayers' Position

Taxpayers argue that they have the requisite business purpose, but even where they do not, taxpayers argue that I. R. C. § 357(b) does not cause basis reduction under I. R. C. § 358(d)(1), since the exchange did not generate a gain.

Discussion

I. R. C. § 357(a) provides a general rule that in I. R. C. § 351 exchanges, the assumption of a liability by a transferee corporation is not treated as boot. However, an exception to this general rule exists under I. R. C. § 357(b).

I. R. C. § 357(b)(1)[11] provides that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption described in I. R. C. § 357(a) was a purpose to avoid Federal income tax on the exchange, or if not such a purpose, was not a bona-fide business purpose, then such assumption shall, for purposes of I. R. C. § 351, be considered as money received by the taxpayer on the exchange.

---

[11] I. R. C. § 357(b) provides generally:

> (1) In general. — If taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)—
>
> (A) was a purpose to avoid Federal income tax on the exchange, or
> (B) if not such purpose, was not a bona fide business purpose,

then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of § 351, 361, or 371 (as the case may be), be considered as money received by the taxpayer on the exchange.

I. R. C. § 357(b)(1) applies in two cases: (1) where under the applicable circumstances it appears that the principal purpose of the transferor in causing the assumption of the liability was to avoid federal income tax on the exchange; and (2) where there is no tax avoidance purpose but the principal purpose with respect to the assumption was not a bona fide business purpose.

I. R. C. § 357(b)(2) provides that in any suit or proceeding where the burden is on the taxpayer to prove the liability assumption is not to be treated as money received by the taxpayer, the burden shall not be considered sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence. Treas. Reg. §1.357-1(c) provides:

> [T]he taxpayer must sustain such burden by the clear preponderance of the evidence. Thus, the taxpayer must prove his case by such a clear preponderance of all the evidence that the absence of a purpose to avoid Federal income tax on the exchange, or the presence of a bona fide business purpose, is unmistakable.

Courts have recognized the taxpayer's burden under I. R. C. § 357(b)(2) and, where taxpayers have not carried this burden, I. R. C. § 357(b) has been determined to apply. Drybrough v. Commissioner, 42 T.C. 1029, 1047 (1964), aff'd in part and rev'd in part, 376 F.2d 350 (6th Cir. 1967).

I. R. C. § 358(a) provides that the basis of the stock received in an I. R. C. § 351 transaction is the basis of the property transferred, decreased by the amount of money received by the taxpayer.[12] Thus, if I. R. C. § 357(b) applies, the liability assumption is treated as money and decreases the basis of the acquired stock. The application of I. R. C. § 357(b)(1) will result in the assumption of the liabilities being treated as the receipt of money by the transferor on the exchange, and its basis in the transferee preferred stock will be reduced to that extent under I. R. C. § 358(a)(1)(A)(ii). By its terms, assumed liabilities to which I. R. C. § 357(b) applies are considered as money received by the transferor. Thus, when I. R. C. § 357(b) applies to an I. R. C. § 351 exchange, I. R. C. § 358(a)(1)(A)(ii) applies without resort to I. R. C. § 358(d)(1) (in effect, I. R. C. § 358(d)(1) is rendered moot).[13] The subsequent sale of the stock would not, therefore, generate a capital loss. This result is based on the plain language of I. R. C. §§ 351, 357(b) and 358(a).

---

[12] In this case, as in the case of a basis reductions under either section 358(h) or section 358(d)(1), if the transferor and the transferee are members of a consolidated group subsequent to the exchange, then no further adjustment is made to the stock basis when the transferee makes a payment with respect to the assumed liability. See Treas. Reg. § 1.1502-32(a)(2).

[13] Appeals is of the opinion that FSA 199905008 erroneously theorized that whether I. R. C. § 357(b) applies is not determinative of whether an assumed liability will reduce the transferor's basis in the stock of the transferee under I. R. C. § 358(d)(2). That erroneous theory is not binding on the Service; an FSA may not be used or cited as precedent. See I. R. C. § 6110(k)(3). Any reliance by taxpayers on FSA 199905008 is without merit. The position of Counsel on this issue is reflected in the Coordinated Issue Paper dated April 4, 2003.

Compliance's position is that the principal purpose of the liability assumption is to facilitate the creation of high basis, low value stock the disposition of which results in a substantial capital loss, that accelerates and, in some cases, duplicates the deduction of the underlying liability. Such purpose is not a bona fide business purpose. Accordingly, under I. R. C. § 357(b)(1)(B), the assumption of the liability is considered a distribution of money that, under I. R. C. § 358(a), reduces stock basis, thereby eliminating loss on the sale of the shares.

I. R. C. § 357(b) deals with the transferor's purpose in causing the assumption and states that consideration must be given to "the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made." Accordingly, the determination of the transferor's purpose must be made from an analysis of all the facts and circumstances.

I. R. C. § 357(b) was enacted to prevent the tax deferment rule in I. R. C. § 357(a) from encouraging schemes to avoid taxes. Campbell v. Wheeler, 342 F.2d 837, 838 (5th Cir. 1965); Simpson v. Commissioner, 43 T.C. 900, 915 (1965). The assumption of liabilities of the transferor corporation is frequently an integral part of a corporate reorganization. This was recognized by Congress when it amended § 112 of the Internal Revenue Code of 1939 by amending subsection (k), the predecessor of I. R. C. § 357(b). The legislative history[14] states:

> In typical transactions changing the form or entity of a business it is not necessary to liquidate the liabilities of the business and such liabilities are almost invariably assumed by the corporation which continues the business.

The operative code provisions should be applied consistent with the legislative purpose they were designed to serve. See Griffiths v. Commissioner, 308 U.S. 355 (1939).

Taxpayers may assert that there is a potential statutory impediment to the application of I. R. C. § 357(b) to the Contingent Liability Transaction. The language of I. R. C. § 357(b)(1)(A) refers to a tax avoidance purpose "on the exchange." Arguably in the Contingent Liability Transaction, the assumption of the liability is not for purposes of avoiding taxation "on the exchange," since a gain is not generated on the exchange. However, viewing the transaction as a whole, the generation of a capital loss in close proximity to the I. R. C. § 351 exchange may be viewed by a court as a purpose to avoid taxation "on the exchange." See Investment Research Associates Ltd. v. Commissioner, T.C. Memo 1999-407, aff'd sub nom. Ballard v. Commissioner, 321 F.3d 1037 (11th Cir. 2003), aff'd in part and rev'd in part sub nom. Estate of Lisle v. Commissioner, 341 F.3d 364 (5th Cir. 2003).

[14] See H. Rep. No. 855, 76th Congress, 1st Session, pp. 18, 19 (1939), 1939-2 C.B. 504.

In Investment Research Associates, T.C. Memo 1999-407, the Tax Court evaluated a complex series of transactions as a whole, in the context of the parties' motivations, and determined there was no business purpose for the liability assumption. Rather, the purpose was to sell an asset for cash, and the liability assumption constituted a tax avoidance purpose under I. R. C. § 357(b). Relevant factors in the determination were (1) viewing the transaction as a whole, the end result was the sale of a partnership interest for cash; (2) the short period, 3-1/2 months, over which the entire transaction took place; (3) the makers of all the notes were the transferor or its controlled entities, and constituted a circular flow of funds among the controlled entities; and (4) the immediate avoidance of taxable capital gains.

Appeals notes the phrase "on the exchange" is not contained in I. R. C. § 357(b)(1)(B). Based on the clear language of the statute, if the principal purpose is tax avoidance, it is immaterial whether the alternative lack of a bona fide business purpose is present. Likewise, it is immaterial under the statute whether a tax avoidance purpose is present if the principal purpose for the assumption is not a bona fide business purpose. See Weaver v. Commissioner, 32 T.C. 411 (1959), aff'd sub nom. R.A. Bryan v. Commissioner, 281 F.2d 238 (4th Cir. 1960); Drybough v. Commissioner, 42 T.C. 1029 (1964), aff'd on this issue and rev'd in part 376 F.2d 350 (6th Cir. 1967).

Further, the requirement that the principal purpose be a bona fide business purpose is broader in scope, and the courts have found some cases in which the principal purpose was not a bona fide business purpose, but did not rise to the level of tax avoidance. See Stoll Est. v. Commissioner, 38 T.C. 223 (1962), acq. and nonacq. 1967-2 C.B. 3,4; Wheeler v. Campbell, 63-2 USTC 9805 (N.D. Tex. 1963), rev'd 342 F.2d 837 (5th Cir. 1965); Eck v. U.S., 70-2 USTC 9465 (D. N. D. 1969).

Note that I. R. C. § 357(b)(1)(B) applies if the taxpayer's principal purpose is not a bona fide business purpose. Thus, I. R. C. § 357(b) can apply even if the taxpayer in fact has some business purpose.

The relevant principal purpose is the principal purpose of the transferor with respect to the assumption of the liabilities in the transaction. Simpson v. Commissioner, 43 T.C. 900 (1965), acq. 1965-2 C.B. 6. In determining such principal purpose, the statutory scheme directs consideration of the nature of the liabilities and the circumstances in the light of which the arrangement for the assumption or acquisition was made. Id.

Several cases have considered the application of I. R. C. § 357(b), or its predecessor § 112(k). In cases where the courts found a bona fide business purpose, the following factors distinguish those cases from the typical Contingent Liability Transaction: (1) the entire trade or business, or the assets associated with the liability assumed were also transferred; (2) there was no subsequent sale of stock acquired in the transaction shortly after the exchange; (3) there was no immediate loss claimed by the taxpayers; or (4) third party creditors required the businesses to be isolated into separate corporations. Wheeler, 342 F.2d 837; Jewell v. United States, 330 F.2d 761

(9th Cir. 1964); Easson v. Commissioner, 294 F.2d 653 (9th Cir. 1961); Simpson, 43 T.C. 900 (1965), acq. 1965-2 C.B. 6; ISC Industries, Inc. v. Commissioner, T.C. Memo 1971-283.

In cases where no bona fide business purpose was found under I. R. C. § 357(b), courts looked to the whole transaction, the end result of which was to avoid federal income tax; Drybrough 42 T.C. 1029 (1964); Investment Research Associates,T.C. Memo 1999-407; or the purpose of the borrowing was for personal purposes of an individual shareholder; Eck, 70-2 USTC 9465 (D. N. D. 1969); or the liabilities assumed had no relation to the business transferred; Harrison v. Commissioner, T.C. Memo 1981-211.

The typical Contingent Liability Transaction involves the transfer of a liability without the corresponding asset, a subsequent sale of the stock shortly after the exchange that generates a loss, large tax savings in comparison to business savings, if any, and liabilities, the nature of which may not be true liabilities in some cases. The end result of the whole Contingent Liability Transaction is the generation of a capital loss, created by the assumption of a liability which creates a high basis, low fair market value stock.

Taxpayers have a strong evidentiary hurdle to overcome in demonstrating that the principal purpose for entering into the Contingent Liability Transaction was bona fide. The burden of proof rests with the taxpayer to prove by the clear preponderance of the evidence that the assumption of the contingent liability should not be treated as money received by the taxpayer. See Drybrough, 42 T.C. 1029 (1964).

ISSUE 5

Compliance's Position

In cases where the obligations transferred are future obligations which have not yet been incurred, Compliance argues the liability assumption should be treated as a promise to pay. The promise to pay such obligation is not a liability, contingent or otherwise, at the time of the assumption. Since the obligation assumed is not a "liability" within the meaning of I. R. C. § 358(d), the promise to pay is "other property" (boot) within the meaning of I. R. C. § 358(a).

Taxpayers' Position

Taxpayers have claimed that if such obligations are not liabilities under the Internal Revenue Code, they would then not reduce basis under I. R. C. § 358(d).

Discussion

I. R. C. § 358(a)(1)(A)(ii) provides generally that in the case of an exchange to which I. R. C. § 351 applies, the basis of the property permitted to be received without the recognition of gain or loss shall be the same as that of the property exchanged, decreased by the fair market value of any other property (except money) received by the taxpayer. I. R. C. § 358(a)(2) specifies that the basis of any other property shall be its fair market value.

Several Contingent Liability Transactions include the assumption of benefit obligations for a work force in place. For example, the transferee assumes the obligation to pay retirement or health care benefits for current employees as compared with liabilities that are required to be booked under FASB 106. The amount of the obligation is generally estimated using present value calculations. Typically, at the time of the transfer of the obligation, the transferor has incurred no obligation to pay such liabilities and in fact such obligation could be terminated. For example, the taxpayer may have claimed a large capital loss based upon projected workforce liabilities, yet such obligation never accrued because the taxpayer's workforce was eliminated in an acquisition transaction. The nature of these obligations is no different from salaries paid to employees in future years.

Existing jurisprudence provides no liability accrues during a taxable year based on an event that may occur in future years, since the events necessary to create the liability do not occur during the taxable year. See Brown v. Helvering, 291 U.S. 193 (1934).

In Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963), aff'd 333 F.2d 653 (2d Cir. 1964), the Tax Court held that severance pay obligations assumed by a taxpayer could not be included in the cost basis of the assets purchased. The holding was based on the fact that in order to incur an obligation to pay severance pay, notice was required, and the likelihood of the taxpayer incurring such a liability without such notice was remote. The liability was “so speculative” that it could not be fairly considered as part of the cost. Albany Car Wheel, 40 T.C. at 841.

If a liability is merely speculative , its assumption is not included in amount realized in an I. R. C. § 1001 transaction. The term “liability” means the same thing in I. R. C. §§ 357 and 1001. Therefore the assumption of a speculative liability in an I. R. C. §351 exchange is not an assumption of a liability under I. R. C. § 357.

However, something of value was given in addition to the stock, in the form of a promise to pay. I. R. C. § 358(a)(1)(A)(ii) provides generally that in the case of an exchange to which I. R. C. § 351 applies, the basis of the property permitted to be received without the recognition of gain or loss shall be the same as that of the property exchanged, decreased by the fair market value of any other property (except money) received by the taxpayer. I. R. C. § 358(a)(2) specifies that the basis of any other property shall be its fair market value. If the promise to pay does not rise to the level of a liability, based on the facts of the particular case, then the promise to pay is boot and the taxpayer’s basis in the stock received in the exchange is reduced in the amount of the promise to pay.

ISSUE 6

Compliance’s Position

Compliance argues in some cases that the stock received by the transferor may be nonqualified preferred stock within the meaning of I. R. C. § 351(g), or that the stock sale may otherwise be disregarded or recast as a loan.

Taxpayers’ Position

Taxpayers argue the shares sold have the characteristics of equity, and should therefore not be disregarded or recast as a mere loan or financing arrangement.

Discussion

In the transactions under consideration, taxpayers claim to have recognized capital losses on their sale of stock received in the I. R. C. § 351 exchanges. Often, no after-market exists for the sold stock and the stock, in the purchaser's hands, is subject to transfer restrictions, such as a right of first refusal exercisable by the taxpayer. Typically, the purchaser can, however, "put" the stock back to the taxpayer, or cause the issuing corporation to redeem it; and the taxpayer can "call" the stock, or the issuing corporation can force its redemption on the purchaser. In other cases, the dividend rate is akin to that of an interest rate or other similar indices. In many cases, statements by the purchasers suggest that the stock was purchased because of the rate of return on the stock, and such return was effectively guaranteed, by caps and floors on the equity participation, and/or the purchaser was indemnified from loss by the taxpayer. In cases involving these types of facts, the stock may be governed by I. R. C. § 351(g), or the sale of stock could be disregarded based on similar judicial principles.

351(g)

For transactions occurring after June 8, 1997, I. R. C. § 351(g)(1) provides that in the case of a person who transfers property to a corporation and receives nonqualified preferred stock, I. R. C. § 351(a) shall not apply to such transferor, and if (and only if) the transferor receives stock other than nonqualified preferred stock, I. R. C. § 351(b) shall apply to such transferor and such nonqualified preferred stock shall be treated as other property for purposes of applying I. R. C. § 351(b).

I. R. C. § 351(g)(2) defines "nonqualified preferred stock" as stock where:

(i) the holder of such stock has the right to require the issuer or a related person to redeem or purchase the stock,
(ii) the issuer or a related person is required to redeem or purchase such stock,
(iii) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or
(iv) the dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.

The above clauses (i), (ii), and (iii) apply only if the right or obligation referred to therein may be exercised within the 20-year period beginning on the issue date of such stock and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase. I. R. C. § 351(g)(2)(A).

I. R. C. § 351(g)(3)(A) defines “preferred stock” as stock that is limited and preferred as to dividends, and does not participate in corporate growth to any significant extent. Although there are several limitations and exceptions, generally nonqualified preferred stock includes stock that can be viewed as more secure than the average share of preferred stock. There is no case law specifically defining “preferred stock” under I. R. C. § 351(g).

Judicial Principles

The substance of a transaction, rather than its legal form, is controlling for tax purposes. Helvering v. Lazarus and Co., 308 U.S. 252 (1939). Where there is a genuine multiple party transaction with economic substance that is compelled or encouraged by business or regulatory realities, that is imbued with tax-independent considerations, and that is not shaped solely by tax avoidance features to which meaningless labels are attached, the form of the transaction chosen by the taxpayer should govern. Frank Lyon Company v. United States, 435 U.S. 561 (1978).

Whether a sale of the stock has taken place depends on whether the benefits and burdens of ownership have been transferred. Kwiat v. Commissioner, T.C. Memo 1992-433; Merrill v. Commissioner, 40 T. C. 66 (1963), aff'd per curiam 336 F.2d 771 (9th Cir. 1964). The presence of reciprocal puts and calls is not necessarily sufficient to demonstrate that a sale for tax purposes has taken place. Kwiat, T.C. Memo 1992-433. The Tax Court in Kwiat noted, however, that the existence of reciprocal puts and calls undoubtedly shifts substantial benefits and burdens of ownership. Following the Court's reasoning, because of the put, the burden of any economic depreciation to the purchaser is limited. Similarly, because of the call, the benefit of any appreciation to the purchaser is also limited. The difference in the put and call price may well be recast as interest on the monies invested by the purchaser, along with a fee for accommodating the transaction, especially in cases where the purchaser has an ongoing business relationship with the transferor, such as employment, or ongoing administrative service contracts, and the transferor has agreed to indemnify the purchaser against loss.

In considering whether there has been a sale, the following factors are relevant: whether the transferor continued to pay normal operational expenses; whether the repurchase price is predetermined; and whether the parties intended for the transferor to repurchase the stock within a specified period of time. See Rev. Rul. 72-543, 1972-2 C.B. 87.

Penn Dixie Steel Corp. v. Commissioner, 69 T.C. 837(1978), specifically addresses the issue of whether the put and call arrangements legally, or as a practical matter, imposed a mutual obligation to sell and buy back the outstanding stock. In this regard the Tax Court looked at both whether the put and call options were exercisable and expired on the same date, and whether the possibility that neither option would be exercised is remote. Based on the facts of that case (taxpayer argued that the transaction was a sale), the Court concluded that there was more than a remote possibility that non-simultaneous options might not be exercised.

The rate of return is relevant to consideration of whether the Contingent Liability Transaction should be considered a loan; Kwiat, T.C. Memo 1992-433, or the stock boot; I. R. C. § 351(g)(2)(iv).

ISSUE 7

Compliance's Position

Compliance argues the substance of the transaction requires the recharacterization or disregard of all or a part of the transaction, under the judicial doctrines of lack of economic substance or step transaction, depending upon the facts of a particular transaction.

Taxpayers' Position

Taxpayers generally believe their business purpose, to provide an incentive to the shareholders of the LMC, is a sufficient business purpose to overcome any arguments under the above cited judicial doctrines.

Discussion

As discussed above, the courts frequently distinguish between "form" and "substance," asserting that transactions are to be taken at face value for tax purposes only if they are imbued with a "business purpose" or reflect "economic reality," and integrate all steps in a prearranged plan rather than give effect to each step as though it were a separate transaction. These criteria, generally known as the "sham," "substance over form," and "step transaction" doctrines, are axiomatic, creating a judicial framework within which all statutory provisions are to function. See Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935).

Substance over form and related judicial doctrines all require "a searching analysis of the facts to see whether the true substance of the transaction is different from its form or whether the form reflects what actually happened." Harris v. Commissioner, 61 T.C. 770, 783 (1974). The issue of whether any of those doctrines should be applied involves an intensely factual inquiry. See Gordon v. Commissioner, 85 T.C. 309, 327 (1985), Gaw v. Commissioner, T.C. Memo 1995-531, aff'd without published opinion, 111 F.3d 962 (D.C. Cir. 1997).

Sham Transaction Doctrine

The sham transaction doctrine originated with the Supreme Court's decision in Gregory, 293 U.S. 465 (1935). See also Knetsch v. United States, 364 U.S. 361 (1960). Under this doctrine, a transaction that is not in substance what it purports to be in its form may be viewed as a mere sham and disregarded for tax purposes.

The taxpayer has the burden of showing that the form of the transaction accurately reflects its substance, and the deductions are permissible. National Starch and Chemical Corp. v. Commissioner, 918 F.2d 426, 429 (3d Cir. 1990).

The sham transaction doctrine requires a thorough examination of the challenged transaction as a whole as well as each step thereof, to determine if the substance of the transaction is consistent with its form. ACM Partnership v. Commissioner, 157 F.3d 231, 246 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999).

Compliance argues certain aspects of these cases typically suggest the application of this doctrine. In particular, Compliance argues that close scrutiny be given to the arrangements through which the purportedly assumed liability is paid. Typically, these cases involve the transfer of an inter-company note to the corporation that purportedly assumes the liability, but at the same time there are put in place (as part of the overall plan) interrelated, complicated, and circular financial arrangements pursuant to which the transferor or some other group member actually pays the claims. The “payments” are charged against an “account” of the transferee, as are “payments” purportedly received by the transferee with respect to the inter-company note that funded the original exchange. Often there are credit facilities between the transferor and the transferee pursuant to which all payments in settlement of claims are “loaned” by the transferor to the transferee, and all reimbursements are “loaned” by the transferee to the transferor. In this manner, the transferor retains control over the financing of the liabilities and, as a result, it can be argued that the note was in fact a sham, as was the assumption of the liability (if in fact there is a liability at all for tax purposes).

Compliance stresses the argument is not that there is no economic substance to the overall transaction, or even to the note and liability, but rather that the substance of the purported note transfer and liability assumption was actually just a complicated financing arrangement among members of a consolidated or controlled group--shams that cannot be respected for tax purposes. See, e.g., National Lead Company v. Commissioner, 336 F.2d 134 (2d Cir. 1964).

In National Lead, the court held that an inter-corporate sale of stock at a loss by a parent corporation to its wholly owned subsidiary had no reality for tax purposes and, thus, must be disregarded (because of the parent’s continuing control over the property for fifteen years following the alleged sale). Thus, the parent was taxed on dividends and profits from the resale of such property by the subsidiary in the intervening years. While the court did not completely disregard the separate corporate identity of the subsidiary, it disregarded the inter-corporate stock sale as a sham.

Lack of Economic Substance

Notice 2001-17 sets forth the Service position that Contingent Liability Transactions lack economic substance and should be disregarded for tax purposes. When a transaction lacks economic substance, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction. A transaction that is entered into primarily to reduce taxes and that has no economic or commercial objective is without effect for federal income tax purposes. Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Rice's Toyota World Inc. v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985). In addition, even transactions having an economic effect may be disregarded if they are tax motivated and have no business purpose. Karr v. Commissioner, 924 F.2d 1018, 1023 (11th Cir. 1991).[15]

An economic substance analysis hinges on all of the facts and circumstances surrounding the transactions leading up to and involved in a series of transactions. No single factor will be determinative. Whether a court will respect the taxpayer's characterization of the transaction depends on whether there is a bona fide transaction with economic substance, compelled or encouraged by business or regulatory realities, imbued with tax-independent considerations, and not shaped primarily by tax avoidance features that have meaningless labels attached. See Frank Lyon, 435 U.S. 561 (1978); ACM Partnership, 157 F.3d 231 (3d Cir. 1998), aff'g in part T.C. Memo 1997-115; Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990); Rice's Toyota World, 752 F.2d 89 (4th Cir. 1985), aff'g in part 81 T.C. 184 (1983); Winn-Dixie v. Commissioner, 254 F.3d 1313 (11th Cir. 2001), aff'g 113 T.C. 254 (1999).

In ACM Partnership, T.C. Memo 1997-115, the Tax Court found that the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. Courts have further recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of a transaction. Knetsh, 364 U.S. 361 (1960). Modest or inconsequential profits relative to substantial tax benefits are insufficient to imbue an otherwise questionable transaction with economic substance. ACM Partnership, 157 F. 3d at 258; Sheldon v. Commissioner, 94 T.C. 738, 767-768 (1990); Saba Partnership v. Commissioner, T.C. Memo 1999-359, 78 T.C.M. (CCH) 684, 721-722.

Appropriate factors for consideration as to whether the Contingent Liability Transaction lacks economic substance include whether (1) the transfer achieved its stated business purpose (based on objective documentation); (2) the amount of the potential non-tax benefit to be realized by the parties is far exceeded by the losses generated; (3) the transferee corporation is a meaningless shell; (4) property was transferred; (5) there is evidence of pre-arranged plans concerning the future sale of the stock; (6) there is no evidence that independent parties (such as creditors) requested a specific structure for the transaction; and (7) the transaction originated in the tax department, in lieu of the appropriate business unit.

Step Transaction Doctrine

---

[15] Cf. Compaq v. Commissioner, 277 F.3d 778 (5th Cir. 2001) rev'g 113 T.C. 363 (1999), United Parcel Service v. Commissioner, 254 F.3d 1014 (11th Cir. 2001) (Narrowly defines altering the form of an existing bona fide business as a sufficient "business purpose" to "neutralize any tax avoidance motive").

Under the step transaction doctrine, a series of formally separate steps may be collapsed and treated as a single transaction if the steps are in substance integrated and focused toward a particular result. See Andantech v. Commissioner, T.C. Memo 2002-97.

Courts have applied three alternative tests in deciding whether the step transaction doctrine should be invoked in a particular situation: (1) if at the time the first step was entered into, there was a binding commitment to undertake the later step (binding commitment test);[16] (2) if separate steps constitute prearranged parts of a single transaction intended to reach an end result (end result test); or, (3) if separate steps are so interdependent that the legal relations created by one step would have been fruitless without a completion of the series of steps (interdependence test). See Penrod v. Commissioner, 88 T.C. 1415, 1428 -1430 (1987).

More than one test might be appropriate under any given set of circumstances; however, the circumstances need satisfy only one of the tests in order for the step transaction doctrine to operate. Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1527-1528 (10th Cir. 1991) (finding end result test inappropriate but applying the step transaction doctrine using the interdependence test). For a recent detailed discussion of the three alternative tests applied in deciding whether the step transaction doctrine should be invoked in a particular situation, see Andantech v. Commissioner, T.C. Memo 2002-97.

The existence of business purposes or economic effects does not preclude the application of the doctrine:

> Events such as the actual payment of money, legal transfer of property, adjustment of company books, and execution of a contract all produce economic effects and accompany almost any business dealing. Thus we do not rely on the occurrence of these events alone to determine whether the step transaction doctrine applies. Likewise, a taxpayer may proffer some non-tax business purpose for engaging in a series of transactional steps to accomplish a result he could have achieved by more direct means, but that business purpose by itself does not preclude application of the step transaction doctrine.

True v. United States, 190 F.3d 1165, 1177 (10th Cir. 1999). See also Associated Wholesale Grocers,927 F.2d 1517.

---

[16] The purpose of the binding commitment test is to promote certainty in tax planning; it is the most rigorous limitation of the step transaction doctrine. It is seldom used and is applicable only where a substantial period of time has passed between the steps that are subject to scrutiny. Thus, generally it is not an appropriate test to apply to transactions that fall entirely within a single tax year and so will generally not be the preferred test in the cases at issue here. See, e.g., Andantech v. Commissioner, T.C. Memo 2002-97; Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1522 n. 6 (10th Cir. 1991) (rejecting use of the binding commitment test because the case did not involve a series of transactions spanning several years).

In order to collapse a transaction under the step transaction doctrine, the government must have a logically plausible alternative explanation that accounts for all the results of the transaction. Thus, the step transaction doctrine permits a particular step in a transaction to be disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes. Del Commercial Properties, Inc. v. Commissioner, 251 F.3d 210, 213-214 (D.C. Cir. 2001), aff'g T.C. Memo 1999-411; see also Penrod, 88 T.C. at 1428-1430; Tracinda Corp. v. Commissioner, 111 T.C. 315, 327 (1998). The explanation may combine steps, however, courts have generally declined to apply the doctrine where the Government's explanation would invent new steps. See Esmark, Inc. & Affiliated Cos. v. Commissioner, 90 T.C. 171, 196 (1988), aff'd without published opinion 886 F.2d 1318 (7th Cir. 1989). "'Useful as the step transaction doctrine may be . . . it cannot generate events which never took place just so an additional tax liability might be asserted.'" Grove v. Commissioner, 490 F.2d 241, 247-248 (2d Cir. 1973), aff'g T.C. Memo 1972-98 (quoting Sheppard v. United States, 361 F.2d 972, 978 (Ct. Cl. 1966)).

The step transaction doctrine is particularly tailored to transactions involving a series of potentially interrelated steps for which the taxpayer seeks independent tax treatment. True, 190 F.3d at 1177. The "interdependence test" will be strongest in a situation where the liability management company is a shell. The critical inquiry is whether the individual steps of the arrangement make independent economic sense but for the tax benefit (the creation of the loss stock through the I.R.C. § 351 exchange). The "end result test" may also be used to collapse the transaction into an issuance by the transferee of its stock directly to a third party (i.e., the party that, in form, purchased the stock from the transferor).

In this regard, the prearrangement of the sale to the third party is highly significant. In those cases where the stock is sold to an accommodating party, such as a bank or unrelated investor, the sale has no relation to the fulfillment of the taxpayer's business purpose. The transaction only makes sense in the light of the tax loss realized.

The typical Contingent Liability Transaction involves the transfer of the stock to the transferor, followed by its sale to a third party. The purported business purpose is to provide a performance incentive to the third party to increase the value of the company. It can be argued the "end result test" applies to collapse the transaction into a transfer of the shares directly to a third party. While the taxpayer's purported business purpose may speak to the need to organize and contribute property to the LMC, the business purpose could have been achieved equally as well with the LMC issuing the shares directly to the third party. There is no apparent purpose for the *transferor's* sale of shares to the third party, other than to generate a loss on the sale of the shares. This step in the overall transaction only makes sense in the light of the tax loss realized. In most cases, the Service can argue that the complexities of the transaction can only be rationalized in the context of the creation of the high basis stock and the realization of the capital loss.

ISSUE 8

Compliance's Position

In certain cases, Compliance may challenge the value of the liabilities. Compliance argues the valuation may be relevant for two reasons. First, if it can be established that the liability was undervalued, there will be gain recognized on the transaction to the extent the true value of the liability exceeds the basis of the assets transferred. Further, the valuation of the liabilities could affect the credibility of the taxpayer's purported business purpose (since the overvalued liabilities could have been settled at an apparent cost savings), so the fact that the liabilities were overvalued could be used to refute the business purpose argument.

Taxpayers' Position

Taxpayers generally have utilized actuarial and/or present value computations to value their liabilities. In many cases, taxpayers have secured expert opinions.

Discussion

The valuation of the liabilities is a factual issue. Buffalo Tool and Die Manufacturing v. Commissioner, 74 T.C. 441 (1980). If the liabilities are undervalued, there will be gain recognized on the transaction to the extent the true value of the liability exceeds the basis of the asset transferred per I. R. C. § 357(c). Additionally, if the liability has been overvalued, (and so capable of being settled at an apparent cost savings) any purported cost savings on the transaction would be suspect, casting doubt on the credibility of the taxpayers' purported business purpose.

ISSUE 9

Compliance's Position

If the taxpayer respects the existence of the liability management company (the LMC), the liability management company will claim any subsequent deductions or tax benefits resulting from the payment of the liabilities. Compliance argues that pursuant to Holdcroft, 153 F. 2d 323 (8th Cir. 1946), as well as I. R. C. §§ 162, 404, 419 and 482, the transferee is not entitled to the deduction.[17]

[17] Rev. Proc. 2002-67 permits taxpayers who elect the Fast Track Option to negotiate with the Service as to whether the transferor or the transferee receives subsequent tax benefits. This provision is part of the settlement and should not be construed to create any inference that the transferee is entitled to the deduction.

Compliance alternately argues that a taxpayer is not entitled to claim both a deduction for the stock loss in issue and a deduction for payment of the contingent liability. Thus, in the event that the transferor's stock loss is, or has been, allowed, the transferor (as well as any consolidated group of which it is a member) is not entitled to any tax benefit arising from payments in satisfaction of the transferred liability. Similarly, to the extent that the transferor (again, as well as any consolidated group of which it is a member) has enjoyed the tax benefits associated with any payments made with respect to the liability, it is not entitled to any part of a loss otherwise allowable with respect to the disposition of stock received in the Contingent Liability Transaction.

Taxpayers' Position

Taxpayers generally have claimed the deductions on the transferee LMC returns in the year they are paid. Taxpayers further argue that, notwithstanding the duplication of a single economic loss, the transferor (including any consolidated group of which the transferor and transferee are members) is entitled to both a stock loss and a deduction for the payment of the assumed liability.

Discussion

As discussed at Issue 3 above, the transferor remains the taxpayer entitled to claim the deduction arising from the satisfaction of the liability (if otherwise allowable), due to the provisions of I. R. C. § 162, the rule set forth in Holdcroft, 153 F.2d 323 (8^{th} Cir. 1946), I. R. C. § 404, I. R. C. §§ 419 and 419A, I. R. C. § 482, and the distinguishing factors which render Rev. Rul. 95-74 not applicable to Contingent Liability Transactions.

The transferor is the taxpayer claiming the loss on the stock sale. If the transferor and transferee are members of a consolidated group, the group is the taxpayer on whose return the tax benefits associated with the payment of the liability and the stock sale are claimed (irrespective of which entity (the transferor or transferee) purports to claim the deduction for the liability payment). In either case (i.e., whether the transferor or the transferee has claimed the deduction), a single taxpayer is attempting to avail itself of the tax benefits associated with both the payment of the liability and the sale of the stock received in the Contingent Liability Transaction.

In Charles Ilfeld Co. v. Hernandez, 292 U.S. 62 (1934), the Supreme Court held that the common parent of a consolidated group was not entitled to a loss deduction with respect to its investment in two subsidiaries. The subsidiaries had incurred operating losses over a number of years which were used to offset the parent's income on the group's consolidated return. Subsequently, the subsidiaries sold all their assets, paid off debts, and then distributed the remaining proceeds to the parent in liquidation. The taxpayer argued that the distributions occurred after the consolidated return period, and were to be treated as sales.

Examining the consolidated return regulations then in effect, the Supreme Court disagreed, reasoning that the distributions had occurred during the consolidated return period and thus constituted intercompany transactions for which no deduction was allowed. Id. at 67-68. More importantly, the court noted the absence of any authority specifically allowing the claimed losses, stating bluntly that "[i]n the absence of a provision in the Act or regulations that fairly may be read to authorize it, the deduction claimed is not allowable." Id. at 66. The Court then went on to add the following:

> The allowance claimed would permit petitioner twice to use the subsidiaries' losses for the reduction of its taxable income. By means of the consolidated returns in earlier years it was enabled to deduct them. And now it claims for 1929 deductions for diminution of assets resulting from the same losses. If allowed, this would be the practical equivalent of a double deduction. In the absence of a provision of the Act definitely requiring it, a purpose so opposed to precedent and equality of treatment of taxpayers will not be attributed to lawmakers.

Id. at 68. Although an alternative basis for the Court's decision, the prohibition against double deductions was almost immediately adopted as the Ilfeld doctrine, as the Ilfeld case has been uniformly and repeatedly cited as foremost standing for this proposition. Indeed, with respect to corporations filing consolidated returns, a long line of authority has affirmed the Ilfeld principle that a direct or indirect double deduction of the same economic loss is not allowed.

In United States v. Skelly Oil Co., 394 U.S. 678 (1969), the Supreme Court extended the Ilfeld doctrine beyond the specific context of corporations filing consolidated returns. See also Reliable Incubator and Brooder Co. v. Commissioner, 6 T.C. 919 (1946) (disallowing an otherwise allowable deduction in an open year because the taxpayer-petitioner, a corporation filing on a separate return basis, had erroneously deducted the same expense in a prior, closed year). As articulated in Skelly Oil, the Supreme Court cited Ilfeld for the proposition that "the Code should not be interpreted to allow [a taxpayer] 'the practical equivalent of a double deduction,' absent a clear declaration of intent by Congress." Skelly Oil, 394 U.S. at 684 (citations omitted). The Skelly Oil reformulation of the Ilfeld doctrine has frequently been cited by lower courts as a general canon of statutory construction. See Transco Exploration Co. v. Commissioner, 949 F.2d 837, 840-41 (5th Cir. 1992) ("Skelly and Ilfeld offer an important canon of statutory construction: whenever possible, tax provisions should be interpreted so as to avoid the practical equivalent of double deductions.")

In cases where the courts have declined to apply the Ilfeld doctrine, it has been because the duplicative tax benefit was explicitly authorized by the Code or a regulatory provision. See Gitlitz v. Commissioner, 531 U.S. 206 (2001); Woods Inv. Co. v. Commissioner, 85 T.C. 274 (1985); CSI Hydrostatic Testers, Inc. v. Commissioner, 103 T.C. 398 (1994), aff'd per curiam 62 F.3d 136 (5th Cir. 1995); but cf. Wyman-Gordon Co. v. Commissioner, 89 T.C. 207 (1987) (the court applied the

Ilfeld doctrine to deny what it viewed to be a double benefit because neither the Code nor the regulations authorized the duplicative deduction).

In the case of a Contingent Liability Transaction, the duplicative benefit is not mandated by the Code or the regulations. Rather, the duplicative benefit would be the result of a taxpayer applying two general deduction provisions—I. R. C. § 165 to the stock loss and I. R. C. § 162 to the payment of the contingent liability—to a single economic loss. It is a well established principle of tax law that such provisions do not entitle taxpayers to a deduction, for deductions are a matter of legislative grace and taxpayers must show they come squarely within the terms of the law conferring the benefit sought. Welch v. Helvering, 290 U.S. 111, 115 (1933). The statutes involved here both require that a taxpayer suffer a genuine economic loss in order to claim the benefit authorized under the provision. See Treas. Reg. § 1.161-1 ("Double deductions are not permitted."); Treas. Reg. § 1.162-1(a) (General authorization for deduction of business expenses "except items which are used as the basis for a deduction or a credit under provisions of law other than [I.R.C.] § 162"); Treas. Reg. § 1.165-1(a), (b) (Deduction for "any loss actually sustained," "Only a bona fide loss is allowable.").

Accordingly, where the transferor and transferee are not members of a consolidated group and file separate returns, an impermissible double deduction arises when the *transferor* claims a deduction for both the stock loss and for payment of the assumed liabilities. In such a case, the duplicative (i.e., second) deduction must be disallowed. Thus, for example, where the transferor and transferee file separate returns, and the transferor's stock loss is, or has been, allowed, then pursuant to the Ilfeld doctrine the transferor is not entitled to any tax benefit (e.g., a deduction) arising from payment of the transferred liability. Although no double deduction would arise in the separate return context if the transferee was entitled to, and did, claim the deduction for payment of the assumed liabilities, such is not the situation in these cases because the transferee is not entitled to any such deduction (see the discussion at Issue 3 above).

Within the context of a consolidated group, an impermissible double deduction arises when the transferor claims a deduction for the stock loss and any member of the group (including the transferor and the transferee) claims a deduction for payment of the assumed liabilities. Again, however, in these cases only the transferor is otherwise entitled to claim a deduction for payment of the assumed liabilities. In any case, if both deductions (for the stock loss and the liability payment) are claimed on the group return, then the duplicative (second) deduction (whether for the stock loss or the liability payment) must be disallowed.

Consolidated taxpayers may argue that the basis adjustment rules of Treas. Reg. § 1.1502-32 eliminate any duplication inherent in the deduction of the stock loss and the deduction for payment of the liabilities. This argument, however, is misplaced. The stock loss claimed by the transferor will not give rise to any basis adjustments in any remaining transferee stock held by the transferor (at least with respect to transactions not affected by Treas. Reg. §1.1502-35T). Upon payment of the assumed liabilities, there will be no adjustment to the basis of the transferee stock because the liabilities were accounted for in the stock basis on the assumption.

Note that in cases in which the statute of limitations has closed the year of the stock loss, and the adjustment in issue is the disallowance of any deduction from payment of the liabilities under the Ilfeld doctrine, Taxpayers may seek a settlement involving the application of the mitigation of the statute of limitations provisions of I. R. C. §§ 1311-1314. Where applicable, Appeals Officers may take the mitigation provisions into account in effecting a settlement of this issue.

ISSUE 10

Compliance's Position

Compliance recommends assertion of the accuracy-related penalty under I. R. C. § 6662 for negligence or disregard of rules or regulations, a substantial understatement of income tax, or a substantial valuation misstatement against a taxpayer for engaging in a Contingent Liability Transaction in applicable cases.

Taxpayers' Position

Taxpayers generally have secured tax opinions from outside accounting and legal firms. They generally believe these opinions are sufficient to warrant full concession of penalties proposed.

Overview of the Issue

In Notice 2001-17, 2001-1 C.B. 730, the Service stated that it may impose penalties on participants in Contingent Liability Transactions, or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under I. R. C. § 6662, the return preparer penalty under I. R. C. § 6694, the promoter penalty under I. R. C. § 6700, and the aiding and abetting penalty under I. R. C. § 6701.

On January 14, 2002, in Announcement 2002-2, 2002-2 I.R.B. 304, the Service announced a disclosure initiative to encourage taxpayers to disclose their tax treatment of tax shelters and other items for which the imposition of the accuracy-related penalty may be appropriate if there is an underpayment of tax. In return for a taxpayer disclosing any item in accordance with the provisions of this announcement before April 23, 2002, the Service agreed to waive the accuracy-related penalty under I. R. C. § 6662(b)(1), (2), (3), and (4) for any underpayment of tax attributable to that item.

On October 28, 2002, in Rev. Proc. 2002-67, 2002-43 I.R.B. 733, the Service announced a settlement initiative to encourage taxpayers to resolve cases involving

Contingent Liability Transactions that are the same as or substantially similar to those described in Notice 2001–17 for which the imposition of the accuracy-related penalty may be appropriate if there is an underpayment of tax. Taxpayers were given an extended deadline of March 5, 2003 (see Announcement 2002-110) to apply for the settlement initiative.

The Contingent Liability Transaction settlement initiative provided a choice of two methods for arriving at a settlement, the Fixed Concession Procedure and the Fast Track Dispute Resolution Procedure. Taxpayers eligible for the Fixed Concession Procedure were those who (a) had already made a disclosure under terms of Announcement 2002-2, or (b) had been prevented from doing so because the issue was raised in a case under examination. Eligible taxpayers who qualified for and elected the Fixed Rate Concession Procedure were provided with automatic waiver of the accuracy-related penalty under I. R. C. § 6662(b)(1), (2), (3), and (4) for any underpayment of tax attributable to a Contingent Liability Transaction.

Taxpayers who (a) had already made a disclosure under terms of Announcement 2002-2, or (b) had been prevented from doing so because the issue was raised in a case under examination and now complied with its terms also had the option of electing the Fast Track Dispute Resolution Procedure – Contingent Liability Cases under § 6 of the Revenue Procedure 2002-67, and receiving penalty waiver.

Certain taxpayers (see Section 3.02 of Rev. Proc. 2002-67) were not eligible to participate in the settlement initiative, and others who were eligible to participate in the Fast Track option did not meet the above requirements for automatic penalty waiver. The penalty concessions available under the initiative are not automatically available to taxpayers who do not qualify under the terms of the revenue procedure. The settlement of penalties for these taxpayers will be made based on the merits of each case.

Discussion

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

For purposes of I. R. C. § 6662, the term "underpayment" is defined as the amount by which any tax imposed exceeds the excess of the sum of the amount shown as the tax by the taxpayer on his return, plus amounts not so shown previously assessed (or collected without assessment), over the amount of rebates made. IRC § 6664(a)(1), (2); Treas. Reg. § 1.6664-2(a)(1), (2).

Substantial Valuation Misstatement

A 20% accuracy-related penalty attributable to a substantial valuation misstatement may apply where the portion of the underpayment attributable to a substantial valuation misstatement exceeds $5,000 ($10,000 for a corporation, other than an S corporation or a personal holding company). A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such value or adjusted basis. I. R. C. § 6662(e)(1)(A). If the value or adjusted basis of any property claimed on a return is 400 percent or more of the amount determined to be the correct amount of such value or adjusted basis, the valuation misstatement constitutes a "gross valuation misstatement" pursuant to I. R. C. § 6662(h)(2)(A), and a 40% penalty then applies pursuant to I. R. C. § 6662(h)(1).

The amount of the underpayment resulting from a valuation misstatement is determined by comparing a taxpayer's: (1) actual tax liability, i.e., the tax liability that results from a proper valuation and which takes into account any other proper adjustments; with (2) actual tax liability as reduced by taking into account the valuation overstatement. The difference between the two amounts is the understatement attributable to a valuation misstatement. (Staff of the Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, P.L. 97-34).

Where there are multiple reasons for disallowing an entire deduction or credit, not all of which involve overvaluation, the Fifth and the Ninth Circuit Courts of Appeals have construed the above formula to mean that the taxpayer's liability remains the same because the disallowance is based on grounds other than erroneous valuation. Thus, the understatement is not "attributable" to a valuation misstatement; it is attributable to an improper deduction or credit, and the penalty does not apply. Scoville v. Commissioner, 108 F.3d 1386 (9th Cir. 1997); Gainer v. Commissioner, 893 F.2d 225 (9th Cir. 1990); Heasley v. Commissioner, 902 F.2d 380 (5th Cir. 1990); Todd v. Commissioner, 862 F.2d 540 (5th Cir. 1988). Nevertheless, when valuation is an integral factor in disallowing deductions and credits, the valuation misstatement penalty applies.

The above approach has not been followed by other circuits, which hold, for example, that if a transaction lacks economic substance, the taxpayer has a zero basis in the asset upon which he claims entitlement to the deduction, and any basis claimed in excess of that is a valuation overstatement. Zfass v. Commissioner, 118 F.3d 184 (4th Cir. 1997); Illes v. Commissioner, 982 F.2d 163 (6th Cir. 1992) (taxpayer's argument that the underpayment was attributable to an improper deduction rather than a valuation overstatement was a false distinction as the tax benefit generated by the shelter was directly dependent upon the valuation overstatement); Massengill v. Commissioner, 876 F.2d 616 (8th Cir. 1989). In these circuits, if the finding of lack of economic substance is due to an overvaluation, the deficiency is attributable to an overstatement of value and the taxpayer is subject to the penalty. For example, one of the circumstances in which a valuation misstatement may exist is when a taxpayer's claimed basis is disallowed for lack of economic substance. Gilman v. Commissioner, 933 F.2d 143 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992) (applying I. R. C. § 6659, repealed and replaced by I. R. C. § 6662).

With respect to a Contingent Liability Transaction, the "property" claimed on the return for purposes of I. R. C. § 6662(e) is the stock of the liability management company. If the facts establish that the adjusted basis claimed for the stock of the risk or liability management company is 200 percent or more of the correct amount, then a substantial valuation misstatement exists; if the facts establish that the adjusted basis claimed for the stock of the risk or liability management company is 400 percent or more of the correct amount, then a gross valuation misstatement exists.

In many cases, the basis overstatement will be of such a magnitude that a gross valuation accuracy-related penalty will be appropriate.

Substantial Understatement

A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 for a corporation, other than an S corporation or a personal holding company). I. R. C. § 6662(d)(1).

In the case of any item of a taxpayer (other than a corporation which is attributable to a tax shelter), I. R. C. § 6662(d)(2)(B) provides that the amount of the understatement is reduced by any portion of the understatement attributable to an item if (1) the tax treatment of the item by the taxpayer is or was supported by substantial authority for such treatment, or (2) the facts relevant to the tax treatment of the item were adequately disclosed in the return or in a statement attached to the return and there is a reasonable basis for the tax treatment of such item by the taxpayer.

If there is substantial authority for the tax treatment of an item, the item is treated as if it were shown properly on the return for the tax year. Treas. Reg. § 1.6662-4(d)(1). "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)(2). There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. "The weight of authority depends on its relevance and persuasiveness, and the type of document providing the authority." Treas. Reg. § 1.6662-4(d)(3)(ii).

Types of authority include the following: the Internal Revenue Code and other statutory provisions; proposed, temporary and final regulations; revenue rulings and revenue procedures; tax treaties and regulations thereunder; court cases; congressional intent as reflected in committee reports; General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book); private letter rulings and technical advice memoranda issued after October 31, 1976; actions on decisions and general counsel memoranda issued after March 12, 1981; Internal Revenue Service information or press releases; and notices, announcements and other administrative pronouncements published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-4(d)(3)(iii). In addition, a taxpayer can have substantial authority for a position even if it is supported only by a well-reasoned construction of the applicable statute. Treas. Reg. § 1.6662-4(d)(3)(ii).

In addition to satisfying the substantial authority standard, the taxpayer must have reasonably believed that the tax treatment of the item was more likely than not the proper treatment. Treas. Reg. § 1.6662-4(g)(1)(i)(B). There are two ways of meeting this requirement. First, the taxpayer can analyze the pertinent facts and authorities and, in reliance upon that analysis, reasonably conclude in good faith that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by the Service. Treas. Reg. § 1.6662-4(g)(4)(i)(A). Second, the taxpayer can reasonably rely in good faith on the opinion of a professional tax advisor if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities and unambiguously states that the tax advisor concludes that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by the Service. Treas. Reg. § 1.6662-4(g)(4)[18].

In no event will a taxpayer be considered to have reasonably relied in good faith on the opinion of a professional tax advisor unless the requirements of Treas. Reg. § 1.6664-4(c)(1) are met. See Reasonable Cause discussion, below.

Tax Shelter Items

I. R. C. § 6662(d)(2)(C)(i) provides a special rule in the case of any item of a taxpayer other than a corporation which is attributable to a tax shelter. For a taxpayer other than a corporation, if an item is attributable to a tax shelter, the understatement can only be reduced if the treatment of that item is supported by substantial authority and the taxpayer reasonably believed that the treatment of the item was more likely than not the proper treatment. I. R. C. § 6662(d)(2)(C)(i).

---

[18] A "more-likely-than-not" opinion logically can encompass anywhere from 51 percent to 100 percent, however, in the professional community it is generally understood to import only a slight preponderance because higher opinion standards can be used when the opiner believes there is a high probability of a particular outcome. See "The Range of Legal Tax Opinions, With Emphasis on the 'Should' Opinion," by Jasper J. Cummings, Jr., 2003 TNT 33-19.

For purposes of I. R. C. § 6662(d), the term “tax shelter” means a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax (if the transaction was entered into before August 6, 1997, a "principal purpose" standard applies). I. R. C. § 6662(d)(2)(C)(iii).

A non-corporate taxpayer is considered to have reasonably believed that the tax treatment of an item is more likely than not the proper tax treatment if (1) the taxpayer analyzes the pertinent facts and authorities and, based on that analysis, reasonably concludes, in good faith, that there is a greater than fifty-percent likelihood that the tax treatment of the item will be upheld if the Service challenges it, or (2) the taxpayer reasonably relies, in good faith, on the opinion of a professional tax advisor, which clearly states (based on the advisor’s analysis of the pertinent facts and authorities) that the advisor concludes there is a greater than fifty percent likelihood the tax treatment of the item will be upheld if the Service challenges it.[19]

However, I. R. C. § 6662(d)(2)(C)(ii) provides a special rule in the case of corporate tax shelters that I. R. C. § 6662(d)(2)(B) (Reduction for understatement due to position of taxpayer or disclosed item) does not apply to any item of a corporation which is attributable to a tax shelter. Thus, *in the case of a corporate tax shelter*, the existence of substantial authority for the taxpayer’s position and the taxpayer’s reasonable belief at the time that the return is filed, that the treatment of an item is “more likely than not” the proper treatment does not excuse the imposition of the substantial understatement penalty.

I. R. C. § 6662(d)(2)(D) requires the I. R. S. to publish annually a list of positions for which it believes there is no substantial authority; and that affect a significant number of taxpayers. Notice 2001-17 was published on January 18, 2001, alerting taxpayers that the Service may impose penalties on participants in these transactions, including the accuracy-related penalty. Notice 2001-51 also included Notice 2001-17 transactions as one of the “listed transactions.”

Thus, where a taxpayer has a substantial understatement that is attributable to a tax shelter item, the substantial understatement penalty applies, unless the “reasonable cause” exception (discussed below) applies.

<u>Negligence</u>

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. <u>See</u> I. R. C. § 6662(c) and Treas. Reg. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and

---

[19] Treas. Reg. § 1.6662-4(g)(4).

ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499 (5th Cir. 1967), aff'g 43 T.C. 168 (1964).

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. Reasonable reliance, in good faith, upon a tax opinion provided by a professional tax advisor is a defense to the negligence penalty, however, the reliance itself must be objectively reasonable in the sense that the taxpayer supplied the professional with all the necessary information to assess the tax matter and that the professional himself does not suffer from a conflict of interest or lack of expertise that the taxpayer knew of or should have known about. See Treas. Reg. § 1.6664-4(c); Neonatology Associates, P.A. v. Commissioner, 299 F.3d 221 (3rd Cir. 2002) (citing Ellwest Stereo Theatres of Memphis, Inc. v. Commissioner, T.C. Memo 1995-610).

The term “disregard” includes any careless, reckless or intentional disregard of rules or regulations. Treas. Reg. § 1.6662-3(b)(2). Where a taxpayer reported losses from a transaction that lacked economic substance and reported capital losses that would have seemed, to a reasonable and prudent person, to be "too good to be true," then the accuracy-related penalty attributable to negligence may be appropriate. Treas. Reg. § 1.6662-3(b)(2).

Reasonable Cause Defenses

I. R. C. § 6664 provides an exception to the imposition of accuracy-related penalties if the taxpayer shows that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. See I. R. C. § 6664(c).

Treas. Reg. § 1.6664-4(b)(1) states that, in general, the determination of whether a taxpayer acted with reasonable cause and good faith is made on a case by case basis, taking into account all pertinent facts and circumstances. The most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. See 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). See Treas. Reg. §§ 1.6662-4(g)(4)(ii); 1.6664-4(b)(1), (c)(1)(i).

If the transaction is a tax shelter, then, as explained below, the requirements of Treas. Reg. § 1.6664-4(e) should be carefully scrutinized to determine whether a corporate taxpayer had "reasonable cause" sufficient to avoid the accuracy-related penalty attributable to a substantial understatement. If the transaction is not a tax shelter, then Treas. Reg. §§ 1.6664-4(a) through (d) apply in determining whether a corporate taxpayer had reasonable cause sufficient to avoid the accuracy-related penalty.

Reliance on Advice of a Promoter

Taxpayers who received a legal opinion from the promoter or obtained other advice about making the shelter investment may raise as a defense against penalties that they relied on the advice of a tax professional. In United States v. Boyle, 469 U.S. 241 (1985), the Supreme Court entertained this defense, observing that "[m]ost taxpayers are not competent to discern error in the substantive advice of an accountant or attorney." However, reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith, Treas. Reg. § 1.6664-4(b)(1).

Reasonable reliance, in good faith, upon a tax opinion provided by a professional tax advisor is a defense to the negligence penalty, however, the reliance itself must be objectively reasonable in the sense that the taxpayer supplied the professional with all the necessary information to assess the tax matter and that the professional himself does not suffer from a conflict of interest or lack of expertise that the taxpayer knew of or should have known about. See Treas. Reg. § 1.6664-4(c); Neonatology Associates, P.A. v. Commissioner, 299 F.3d 221 (3rd Cir. 2002) (citing Ellwest Stereo Theatres of Memphis, Inc. v. Commissioner, T.C. Memo 1995-610). It is well established that taxpayers generally cannot "reasonably rely" on the professional advice of a tax shelter promoter. See Goldman v. Commissioner, 39 F.3d 402, 408 (2d Cir. 1994) ("Appellants cannot reasonably rely for professional advice on someone they know to be burdened with an inherent conflict of interest."), aff'g T.C. Memo 1993-480; Neonatology Associates, P. A., 299 F.3d at 234 ("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"); Marine v. Commissioner, 92 T.C. 958, 992-993 (1989), aff'd without published opinion 921 F.2d 280 (9th Cir. 1991). Such reliance is especially unreasonable when the advice would seem to a reasonable person to be "too good to be true". Pasternak v. Commissioner, 990 F.2d 893, 903 (6th Cir. 1993), aff'g Donahue v. Commissioner, T.C. Memo 1991-181; Elliott v. Commissioner, 90 T.C. 960, 974 (1988), aff'd without published opinion, 899 F.2d 18 (9th Cir. 1990); Gale v. Commissioner, T.C. Memo 2002-54.

The courts look for certain facts to be established in determining whether to accept the defense. The Tax Court in Neonatalogy, 115 T.C. 43 (2000), aff'd 299 F.3d 221 (3d Cir. 2002), stated that the taxpayer has to satisfy the following three-prong test:

? The advisor was a competent professional who had sufficient expertise to justify reliance;
? The taxpayer gave to the advisor the necessary and accurate information; and
? The taxpayer actually relied in good faith on the advisor's judgment.

Reasonable cause is not established when a taxpayer who claims to have relied upon a tax opinion from an accounting firm or a law firm didn't receive such an opinion until after it had already filed its federal tax return. In this situation, the taxpayer could not have reasonably relied on the tax opinion in reporting the transaction for federal tax purposes.

In the Ninth Circuit, it may be considered advice from an "independent tax professional" even in circumstances that suggest the advice given was influenced by the taxpayer's preferences. See DHL Corp. v. Commissioner, T.C. Memo 1998-461, aff'd in part and rev'd in part on other grounds, remanded by 285 F.3d 1210 (9th Cir. 2002).

In Balboa Energy Fund 1981 v. Commissioner, 85 F.3d 634 (9th Cir. 1996), the Ninth Circuit ruled that reliance on a legal opinion furnished (however, not prepared by) a shelter promoter may be reasonable. The court stated that reliance on the statements made by the shelter promoter himself was not reasonable, but determined that the taxpayers had reasonably relied on a legal opinion given by a law firm in the shelter placement memoranda. The court stated this reliance was reasonable "absent some evidence that would tell a prospective investor that the opinion of a reputable CPA or law firm should be suspect".

Substantial Understatement – Corporate Tax Shelters

Treas. Reg. § 1.6664-(e) provides special rules for establishing reasonable cause in the case of the substantial understatement penalty attributable to corporate tax shelters. All facts and circumstances should be taken into account.

Treas. Reg. § 1.6664-(e)(2) establishes minimum standards where reasonable cause is based upon a legal justification. A finding of reasonable cause may be made only where if substantial authority within the meaning of § 1.6662-4(d) exists, and if based upon all facts and circumstances, the corporation reasonably believed, at the time the return was filed, that the tax treatment of the item was more likely than not the proper tax treatment, based upon an analysis of all the pertinent facts and authorities as outlined in Treas, Reg. § 1.6662-4(d)(3)(ii).

These minimum standards are not dispositive of the issue, and other factors are required to be considered, even when the minimum standards are met. For example, where a taxpayer's participation in the tax shelter lacked a significant business purpose, or where the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's investment in the tax shelter, or where the taxpayer agreed with the promoter to protect the confidentiality of the tax aspects of the tax shelter, a finding of reasonable cause may be precluded. Treas. Reg. § 1.6664-4(e)(3).

Conclusion

Whether penalties apply to the underpayment attributable to the disallowance of capital losses claimed from the transaction must be determined on a case-by-case basis depending on the specific facts and circumstances of each case.

SETTLEMENT GUIDELINES

GENERAL POINTS

[redacted] #
#
#
#
#

[redacted] #
#
#
#
#
#
#

The legal arguments under I. R. C. § 357(c)(3) and I. R. C. § 357(b) have significant merit and should apply in all cases. The availability of other arguments may vary considerably (e.g., failure to satisfy the technical requirements of I. R. C. § 351, or the application of I. R. C. § 351(g)). Given that different arguments have different settlement ranges, care should be taken to assess all of the arguments in determining the appropriate settlement range for a given case.

ISSUE 1

Although most Contingent Liability Transactions likely will adhere to the technical requirements of I. R. C. § 351, whether a taxpayer has satisfied those requirements must be thoroughly vetted. No concession should be made where the technical requirements of I. R. C. § 351 are not satisfied.

ISSUE 2

No concession should be made where I. R. C. § 358(h) is applicable.

ISSUE 3

For the legal argument under I. R. C. § 357(c)(3), [redacted] #
#

ISSUE 4

The legal argument under I. R. C. § 357(b) is inherently factual. Note that the taxpayer has the burden of proving that the principal purpose for the liability assumption was a bona fide business purpose. Appeals believes that in most cases the objective facts will be inconsistent with, if not altogether undermine, the taxpayer's purported business purpose. In such cases, taxpayers will be unable to satisfy their burden of proof with respect to the business purpose requirement of I. R. C. § 357(b). Depending on the facts of a given case, settlement [redacted] #
#

ISSUE 5

The legal argument that the assumed obligation is not a "liability" for purposes of the Code, and therefore its assumption is boot, factually turns on the nature of the obligation. Where the obligation is determined to be a mere promise to pay, [redacted] #
#

ISSUE 6

No concession should be made if I. R. C. § 351(g) applies.

The legal argument that no sale of the loss stock occurred is intensely factual, and it is strongly recommended that an expert be used to develop the relevant facts. The hazards inherent in recasting the sale of stock as a mere loan/financing arrangement are dependent upon the facts and circumstances and case development.

ISSUE 7

Legal arguments that judicial doctrines such as sham transaction, lack of economic substance, and step transaction are inherently factual. Settlement of a particular case will depend upon its facts and circumstances.

ISSUE 8

In cases where Compliance challenges the valuation of the liabilities, the hazards of litigation are dependent upon the factual development in the record. In such cases, the use of an expert is recommended.

ISSUE 9

In all cases, the taxpayer faces significant hazards that the transferee is not entitled to the deduction (as opposed to the transferor). No concession of this issue is recommended.

In the case of a Contingent Liability Transaction in which the transferor and the transferee are members of a consolidated group and the stock loss in issue is, or has been, allowed, neither the transferor nor any other member of the group is entitled to a deduction for payment of the contingent liability under the Ilfeld doctrine. No concession of this issue is recommended.

ISSUE 10

As noted above, on January 14, 2002, in Announcement 2002-2, 2002-2 I.R.B. 304, the Service announced a disclosure initiative to encourage taxpayers to disclose their tax treatment of tax shelters and other items for which the imposition of the accuracy-related penalty may be appropriate if there is an underpayment of tax. In return for a taxpayer disclosing any item in accordance with the provisions of this announcement before April 23, 2002, the Service would waive the accuracy-related penalty under I. R. C. § 6662(b)(1), (2), (3), and (4) for any underpayment of tax attributable to that item.

On October 28, 2002, in Rev. Proc. 2002-67, 2002-43 I.R.B. 733, the Service announced a settlement initiative to encourage taxpayers to resolve cases involving Contingent Liability Transactions that are the same as or substantially similar to those described in Notice 2001–17 for which the imposition of the accuracy-related penalty may be appropriate if there is an underpayment of tax. Taxpayers eligible for waiver of penalties under the initiative were those who (a) had already made a disclosure under terms of Announcement 2002-2, or (b) had been prevented from doing so because the issue was raised in a case under examination and now complied with its terms.

Certain taxpayers (see Section 3.02 of Rev. Proc. 2002-67) were not eligible to participate in the settlement initiative. The penalty concessions available under the initiative are not automatically available to ineligible taxpayers. The settlement of penalties for these taxpayers will be made based on the merits of each of these cases.

Whether penalties apply to the underpayment attributable to the disallowance of capital losses claimed from the transaction must be determined on a case-by-case basis depending on the specific facts and circumstances of each case.

Valuation Misstatement Penalty

The typical Contingent Liability Transaction involves the overstatement of basis of the stock sold, which generates a large capital loss. The basis is overstated due to the misapplication of I. R. C. §§ 357, 358, and the judicial doctrines. The overvaluation of the stock is an essential element in deriving the benefits from the transaction. Therefore, the valuation misstatement component of the accuracy-related penalty should be asserted in cases with a typical fact pattern.

Hazards do exist under the rule of Golsen v. Commissioner, 54 T.C. 742 (1970), aff'd 445 F.2d 985 (10th Cir. 1971), for cases appealable to the Fifth and Ninth Circuits. See Scoville v. Commissioner, 108 F.3d 1386 (9th Cir. 1997); Gainer v. Commissioner, 893 F.2d 225 (9th Cir. 1990); Heasley v. Commissioner, 902 F.2d 380 (5th Cir. 1990); Todd v. Commissioner, 862 F.2d 540 (5th Cir. 1988). However, since the adjustments proposed herein do not result in a full disallowance of the basis, and the valuation was integral to deriving the tax benefits from the shelter, the fact pattern in the typical Contingent Liability Transaction is distinguishable from the foregoing cases. Also, in light of the rationale set forth in the Service's non-acquiescence in Heasley, Appeals views the hazards for the taxpayer greater than the hazards for the government in the impacted Circuits.

Negligence

The determination of whether the negligence component of the accuracy-related penalty is applicable to any portion of the underpayment attributable to the Contingent Liability Transaction is predicated upon the facts and circumstances of the taxpayer's case.

Substantial Understatement

Appeals believes the weight of the Code, regulations and judicial doctrines that deny the tax benefits claimed in this transaction far outweigh any authorities cited by taxpayers, and the hazards to the taxpayer far outweigh the hazards to the government. Appeals also believes, based on judicial doctrines discussed herein, the transaction is likely to be determined to meet the definition of "tax shelter," and the penalty will therefore apply unless, based on the facts of individual cases, reasonable cause is determined to apply.

In the typical Contingent Liability Transaction, taxpayers have generally relied upon Rev. Rul. 95-74 to support their position. (See above discussion, under Issue 3). As noted, the facts of this revenue ruling can be materially distinguished from the typical Contingent Liability Transaction. Therefore, it is likely that the taxpayer will not meet the exception to the penalty on the basis of substantial authority.

Reasonable Cause

The same facts relevant to the substantive issues will bear on the penalties, including the motivation to offset unrelated gain, the prearrangement of the stock sale to a third party, and the transfer of liabilities without the related asset to take advantage of I. R. C. § 357(c)(3).

Taxpayers who received a legal opinion from the promoter or obtained other advice about making the shelter investment may raise as a defense against penalties an argument that they relied on the advice of a tax professional. These opinions should be reviewed in light of the criteria contained in Treas. Reg. § 1.6664-4(e).

In order to constitute reasonable cause in the case of a tax shelter item, the taxpayer must meet the substantial authority requirement. Appeals is of the opinion, based on the typical transaction, that taxpayers did not rely on authority that meets the substantial authority requirement. Therefore, Appeals believes taxpayers face significant hazards in establishing a reasonable cause defense against the penalty in the typical case.