APPEALS

TECHNICAL GUIDANCE

SETTLEMENT GUIDELINES

ISSUE: **TRANSFER OR SALE OF COMPENSATORY OPTIONS OR RESTRICTED STOCK TO RELATED PERSONS NOTICE 2003-47**

COORDINATOR: **Munir I. Ebeid**

TELEPHONE NUMBER: **(972) 308-7493**

UIL NO.: **9300.28.00**

FACTUAL/LEGAL ISSUE: **Legal/Factual**

APPROVED:

/s/ L.P. Mahler
DIRECTOR, TECHNICAL SERVICES

May 24, 2005
DATE

EFFECTIVE DATE: **May 24, 2005**

APPEALS SETTLEMENT GUIDELINES

TRANSFER OR SALE OF COMPENSATORY OPTIONS OR RESTRICTED STOCK TO RELATED PERSONS UIL: 9300.28.0

OVERVIEW

Notice 2003-47[1] describes a transaction whereby the taxpayer takes the position that compensatory income may be deferred until such time as a related party (transferee) satisfies an unsecured unfunded deferred payment obligation, with payment terms of typically 15 to 30 years. To reach that result, the taxpayer points to § 1.83-3(e)[2], arguing that the receipt of such obligation in return for the transfer of compensatory stock options, results in the deferral of compensatory income until such time as the transferee satisfies the obligation. It is the Service's position that neither the statute, regulations or common law doctrines permit such tax avoidance.

If a compensatory stock option or restricted stock is transferred to a related person under terms the same as or substantially similar to those described in Notice 2003-47 the Service will consider raising the following issues. Notwithstanding that the Coordinated Issue Paper includes additional issues with respect to the employer and employment tax ramifications, this ASG will limit the discussion to the issues that impact upon the service provider taxpayer, also referred to herein as "the executive".

ISSUE 1

Whether the transfer is treated as an arm's length transaction for purposes of §§ 1.83-1 and 1.83-7?

It is the Service's position that such transfers are not per se arm's length transactions even if the options or restricted stocks are transferred in exchange for a deferred payment obligation in an amount equal to the fair market value (FMV) of the transferred stock options or restricted stock.

Taxpayers assert that the transfers were made at the FMV and should be treated as arm's length for purposes of § 83. The application of § 83 ends at disposition.

ISSUE 2

Whether the receipt of the deferred payment obligation, such as a note, contractual agreement or annuity, at the time of the transfer results in the immediate recognition of income under §§ 1.83-1 or 1.83-7?

The Service's position is that the receipt of the deferred payment obligation does not alter the timing of the recognition of compensation income. Income is recognizable at the time of the transfer to the family limited partnership (FLP) or other related entity regardless of whether it is at arm's length. The taxpayer's receipt of the deferred payment obligation does not relieve the taxpayer of the duty to report taxable income in the year of the transfer or other disposition of

---

1 2003-30 I.R.B. 132

2 For purposes of this paper, references to a section refer to either a section of the Internal Revenue Code of 1986 or a section of the related Treasury Regulations, except as otherwise indicated.

the stock option. Further, if the transfer is deemed not to be at arm's length, the taxpayer may recognize additional compensation at the time the stock option is exercised or otherwise disposed of by the FLP.

Taxpayers assert that the transaction between the taxpayer and the related party is at arm's length and that § 83 permits the long term deferral of income until such time that the related party satisfies the debt.

ISSUE 3

Whether the transaction may be recast for federal tax purposes under § 1.701-2 is appropriate to achieve tax results that are consistent with the intent of subchapter K?

The Service asserts that under appropriate circumstances the transaction may be recast to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions.

ISSUE 4

Whether the transaction may be challenged under various judicial doctrines?

The Service asserts that under appropriate facts and circumstances, the transaction may be challenged under several common law doctrines, inclusive of, but not limited to the economic substance, sham transaction and step transaction doctrines.

Taxpayers argue that the common law doctrines are inapplicable.

ISSUE 5

Whether the deferred payment obligation should be recognized as a valid debt?

Under appropriate circumstances, the Service will consider whether the underlying debt is bona fide and propose the appropriate adjustments.

Taxpayers assert this is a valid debt for federal income tax purposes.

ISSUE 6

Whether the legal expenses and other fees paid or incurred to create the transaction are deductible under §§ 162 and 212?

The Service's position is that where the transaction in whole or part is a sham, or lacks economic substance, transaction fees will be disallowed.

Taxpayers contest this position and argue that the legal expenses and other fees were properly claimed by the parties who deducted them.

ISSUE 7

Do the disclosure provisions of § 1.6011-4 apply to Notice 2003-47 transactions that were entered into prior to the release of Notice 2003-47?

For those transactions entered into on or after January 1, 2001, for which the transaction was reported on a return filed by June 14, 2002, there is no disclosure requirement under § 1.6011-4. However, if the transaction is entered into on or after January 1, 2001, and the transaction was not reported on a return filed on or before June 14, 2002, the individual, trust, partnership, or S corporation is subject to the disclosure rules under § 1.6011-4 or § 1.6011-4T, as applicable. Those regulations also provide rules applicable for transactions that are subsequently identified as listed transactions.

ISSUE 8

Whether the deficiency attributable to the Notice 2003-47 transaction is subject to the assertion of the negligence or disregard of rules or regulations and/or the substantial understatement of income tax provisions of § 6662.

The government will consider the applicability and assertion of penalties in appropriate circumstances.

It is likely, that taxpayers will assert that the positions claimed were supported by substantial authority and that the executive reasonably believed that the position claimed is more likely than not the proper tax treatment. Taxpayers will likely assert that penalty waiver is warranted under the § 6664 good faith reliance provisions.

FACTS

The transaction generally involves three parties: (1) an individual (taxpayer) who holds compensatory nonstatutory stock options (the executive or service provider); (2) the corporation that granted the options (the employer); and (3) a person or entity related to the individual, such as a family limited partnership (FLP or the related person). The related person purports to purchase the options from the executive in exchange for an unfunded, unsecured long-term balloon payment obligation in an amount allegedly equal to the FMV of the options. The related person may exercise the options but does not make any payments to the executive (except perhaps interest on the obligation) until the balloon payment comes due. There may be some factual variations as to the disposition of the options and how the transaction was implemented. These variations should be considered and a determination made as to whether such variations are material.

The parties generally contend that the purpose of the related person is to aggregate and diversify assets. Often the executive retains the vast majority of the ownership of the related person (for example, up to a 99% limited partnership interest), or may be a general partner in, or manager of, the related person. Generally, the related person is thinly capitalized at the time of the transfer, funded only by the executive's initial contribution of personal stock holdings or cash.

This transaction typically involves the transfer of stock options. However, variations may include transfers of restricted stock or a combination of stock options and restricted stock. The related person receiving the options typically is a FLP, all of the members of which consist of the executive and members of his or her immediate family. Other related persons may include a limited liability corporation or a foreign or domestic trust. Usually, the executive transferring the option is a corporate officer and employee. However, individuals transferring options or restricted stock have included non-employee directors.

The executive transfers the option or restricted stock for a deferred payment obligation payable by the related person to the executive. The obligation may be evidenced by a promissory note, or contained only in the contractual agreement. The obligation typically is structured as an unsecured, non-negotiable 15 to 30-year obligation, with the principal amount not due until the end of the term. The obligation generally provides for stated interest at a rate equal to or greater than the Applicable Federal Rate; often the obligation provides for periodic interest payments. Variations include the use of private annuities as the deferred payment device, often in conjunction with a foreign trust or foreign corporation as the related person.

Typically the promoter prepares, or provides access to a person who prepares a valuation of the stock options at the time of transfer, purporting to use a Black-Scholes or similar methodology. Often, however, the options are valued at a figure equal to the spread (the difference between the FMV of the underlying stock less the exercise price). Thus the stated principal amount of the deferred payment obligation often equals the spread at the date of transfer.

Often the transfer of the stock option, the exercise of the option, and the sale of the acquired stock occur within a very short period of time, for example on the same day or within the same week. When substantially nonvested stock options or restricted stock is transferred, the sale of the underlying stock by the related person typically is delayed until the options or restricted stock vest.

The sale of the acquired stock by the related person typically will generate a capital gain or loss. Where the stock is sold on the same day, the related person may claim that the cost basis equals the amount realized, so that there is no gain or loss.

Different fact patterns may exist. For example, variations could exist with respect to the transaction structure, the type of obligation transferred, the transaction reporting methodology, the timing and amount of the corresponding deduction claimed, the purported business purpose of the related person and the extent to which such business purpose was executed.

At the time of transfer of the stock options and at the time of exercise, the corporation may not issue a Form W-2 to the executive (Form 1099 for non-employee directors) and income may not be reported on the executive's Form 1040. The corporation may have formally agreed not to report the compensation income related to the transfer or exercise of the stock options.

The corporation might not claim a deduction in the year of transfer of the stock options or restricted stock, or the year of exercise of the stock options or vesting of the restricted stock. Rather, the corporation may have agreed to forgo the deduction until principal payments were made on the obligation. In some cases, however, the corporation may have taken a deduction, and perhaps issued a Form 1099 to the related person upon exercise of the stock option.

Fees are paid to the transaction promoters and typically have been deducted by the party who has paid the fees or, fees may have been included in the basis of the related person in calculating gain from the sale of the acquired stock. In some instances, all parties to the transaction may have paid and deducted or included in their basis, promoter fees.

<u>The transaction is alleged to provide some advantages to the executive transferring the options:</u>

? diversification of the executive's portfolio without immediate tax payment due upon exercising stock options;

- ? tax benefit by deferral of recognition of income on compensation income for a long period of time. (I.e. example herein 15 to 30 years);
- ? transaction is not reportable to the IRS as a tax shelter; and
- ? tax opinion is provided to eliminate the penalty if the IRS does not accept the transaction.

The typical 2003-47 transaction involves an executive with a non-statutory stock option who:

- ? forms a FLP and follows specific ownership percentages;
- ? sells his options to the FLP;
- ? the FLP then pays for the options with a long term obligation that is unfunded and unsecured with balloon payment at the end of the deferral period (interest on such obligation is payable annually);
- ? compensation income to the executive is to be reported when the FLP pays the obligation; then
- ? the executive reports no income when the FLP exercises the options and sells the stock.

Taxpayers argue that they relied on a tax opinion which applied the standards of substantial authority and concluded that the executive's tax return position is more likely than not the proper tax treatment. After the tax technique is sold and the executive signs the engagement letter accepting the technique, the promoter typically provides a tax-opinion to the executive indicating the facts reviewed.

Taxpayers further argue that the FLP is a valid taxable entity and the sale of the options was an arm's length business transaction that should be found valid for tax purposes, since § 83 application ended upon the disposition of the options, resulting in the recognition of compensation income when the FLP pays the obligation. Therefore, there was no income assigned and the compensation income is not recognized at the time of disposition, the unsecured/unfunded obligation is not property for purposes of § 83, and the receipt of the obligation does not result in the recognition of income.

Under some of the arguments presented above, taxpayers have noted that the government may present sham transaction, substance over form and constructive receipt arguments.

LAW AND ANALYSIS

§ 83 DISCUSSION

The basic provisions governing the taxation of compensatory nonstatutory stock options and restricted stock are § 83 and the regulations thereunder. To assist in understanding both the executive's arguments and the Service's analysis, a brief outline of § 83 is provided.

§ 83 – Taxation of Property Transferred in Connection with the Performance of Services

§ 83 governs the federal income tax consequences stemming from the transfer of property in connection with the performance of services. Under the general rule of § 83(a) if, in connection with the performances of services, property is transferred to any person other than the person for whom such services are performed, the excess of the FMV at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over the amount (if any) paid for the property shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or are not subject to a substantial risk of forfeiture. Under § 83(a) the excess (if any) of the fair market value of property transferred, over the amount paid (if any) for the property, is includible in the gross income of the person who performed the services for the first taxable year in which the property becomes transferable or is not subject to a substantial risk of forfeiture.

§ 83 and Nonstatutory Stock Options[3]

Although the recipient of a compensatory stock option receives a valuable right, the recipient historically has not recognized income at the time of the option grant unless the option had a readily ascertainable fair market value. See Commissioner v. LoBue, 351 U.S. 243 (1956); § 1.421-6.[4]

This treatment of compensatory stock options generally was continued with the enactment of § 83 and the promulgation of § 1.83-7, which currently govern the taxation of the grant, transfer and exercise of nonstatutory compensatory stock options.

§ 83(e)(3) provides that § 83 shall not apply to the transfer of an option without a readily ascertainable fair market value [at the time of grant]. Further, § 83(e)(4), provides that § 83 shall not apply to the transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at the date of grant.

§ 1.83-7(b) defines when an option will be considered to have a readily ascertainable fair market value at grant. § 1.83-7(b)(1) provides that this standard is met where the option is actively traded on an established market. § 1.83-7(b)(2) provides that if not publicly traded, an option has a readily ascertainable fair market value only if it can be shown that its fair market value can be measured with reasonable accuracy, including a demonstration that the fair market value of the option privilege is readily ascertainable. These standards rarely are met, and thus compensatory nonstatutory stock options typically are not taxed at grant.

Rather, § 83(a) generally applies at the time the options are exercised, resulting in compensation income in an amount equal to the excess, if any, of the fair market value of the stock purchased over (1) the amount, if any, paid for the option (typically zero), plus (2) the amount paid for the stock (the exercise price).

§ 1.83-7(a) provides an exception to this treatment if the recipient of an option not having a readily ascertainable fair market value at the time of the grant sells or otherwise disposes of the option in an arm's length transaction. Specifically, under § 1.83-7(a) if the option is sold or otherwise disposed of in an arm's length transaction, §§ 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as §§ 83(a) and 83(b) would have

---

[3] Nonstatutory stock options refer to options which are not incentive stock options, as defined in Section 422, or options granted under a qualified employee stock purchase plan, as defined in Section 423. Notice 2003-47 transactions should not involve incentive stock options or options under an employee stock purchase plan, as those options are not transferable.

[4] Except as provided in the transition rules under § 1.83-8(b), § 1.421-6 does not apply to options granted on or after July 1, 1969. See § 1.421-6(a)(2).

applied to the transfer of property pursuant to an exercise of the option. Under this treatment, the compensation element is closed at the time of transfer and the option recipient recognizes no further compensation income at the time of exercise of the option.

§ 1.83-7 does not address the federal tax consequences of a non-arm's length transaction. However, an analogy may be made to the regulations governing non-arm's length transfers of substantially nonvested stock. Under § 1.83-1(c), the service provider who receives substantially nonvested stock in connection with the performance of services recognizes income at the time of a non-arm's length transfer of the stock, equal to the amount of any money or substantially vested property received at the time of the transfer. However, the compensation element remains open and that person may recognize further compensation income at the time the stock substantially vests. Analogous rules should apply in the case of a non-arm's length transfer of stock options. At the time of the transfer, the option recipient recognizes income equal to the amount of money or property received at the time of the transfer. However, the compensation element remains open and that person may recognize further compensation income at the time of the exercise of the option. This further compensation would equal the excess of the fair market value of the stock acquired over the sum of (1) the exercise price paid for the stock; (2) the amount included in income at the time of transfer of the option to the related person; and (3) the amount (typically zero) paid by the executive for the option.

§ 83 and Restricted Stock

§ 83(a) provides that if property is transferred in connection with the performance of services, the excess (if any) of the fair market value of property transferred, over the amount paid (if any) for the property, is includible in the gross income of the person who performed the services for the first taxable year in which the property becomes transferable or is not subject to a substantial risk of forfeiture. Thus, the fair market value of stock transferred in connection with the performance of services, less any amount paid for the stock, is includable in income at the time of grant unless the stock is substantially nonvested, meaning that it is both subject to a substantial risk of forfeiture and nontransferable.

Whether the stock is subject to a substantial risk of forfeiture depends on the facts and circumstances. A substantial risk of forfeiture exists where rights in the stock are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. See § 1.83-3(c)(1).

The stock will be considered transferable if the subsequent holder /recipient can transfer any interest in the stock to any person other than the grantor of the stock, but only if the stock transferred is not subject to a substantial risk of forfeiture. See § 1.83-3(d).

Generally the recipient of substantially nonvested stock will recognize income when the stock substantially vests (becomes transferable or is no longer subject to a substantial risk of forfeiture, whichever occurs first). However, if such stock is sold in an arm's length transaction, the transferor recognizes compensation income in an amount equal to the excess of the amount realized on the sale over the amount (if any) paid for the stock. See § 1.83-1(b). If the substantially nonvested stock is transferred in a non-arm's length transaction, the transferor recognizes compensation income in an amount equal to the sum of any money and the fair market value of any substantially vested property received in the transfer. However, § 83 continues to apply to the property. Accordingly, when the stock substantially vests in the hands of the transferee, the original recipient recognizes further compensation income equal to the fair market value of the stock at the time of vesting, less the amount paid (if any) for the stock, which includes any amounts taken into income at the time of the non-arm's length transfer. See § 1.83-1(c) (including example).

§ 83 and Nonqualified Deferred Compensation

§ 83 applies only to transfers of property. The term "property" includes real and personal property, but does not include money or an unfunded and unsecured promise to pay money or property in the future. See § 1.83-3(e). Under this exception, § 83 generally does not apply to benefits under a nonqualified deferred compensation plan.

In contrast, the receipt of a funded promise to pay would result in the immediate recognition of income. Under the economic benefit doctrine, an employee has currently includible income from an economic or financial benefit received as compensation, though not in cash form. Economic benefit applies when assets are unconditionally and irrevocably paid into a fund or trust to be used for the employee's sole benefit. Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd per curiam, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174, Situation 4. This concept has been encapsulated in the definition of property under § 1.83-3(e) which includes a beneficial interest in a trust, the assets of which are set aside from the transferor's creditors. This is true even if the employee has no immediate right to distributions from the trust. On the other hand, where the ***employer's promise*** is evidenced by a bookkeeping entry, backed only by the employer's general assets that are subject to the employer's creditors, the promise generally would not be considered funded. See Rev. Rul. 60-31, Situation 2. No mention is made that this bookkeeping entry can be that of a third party. See Rev. Rul. 69-50, 1969-1 C.B. 140.

The Transaction and the Purported Benefits

Under § 83, compensatory options rarely qualify as having a readily ascertainable fair market value at the date of grant. Accordingly, the executives transferring options as part of a Notice 2003-47 transaction generally have not recognized an amount of income at the time of grant. Rather, the executives would recognize income upon exercise or transfer of the option, whichever occurs first.

The executive argues here that the transfer of stock options to the related person is an "arm's length transaction" under § 1.83-7(a) because he receives an obligation the value of which is equal to the fair market value of the stock options. Under this treatment, §§ 83(a) and (b) apply to the receipt of any money or other property in the transaction in the same manner as §§ 83(a) and (b) would have applied to the transfer of property pursuant to an exercise of the option. However, the compensation element would be closed, and the executive would not be required to include any further compensation upon exercise of the option.

The executive then argues there is no recognition of income at the time of the transfer, but rather the income is deferred until the time payments on the obligation are received. To reach that result, the executive points to § 1.83-3(e), arguing that the obligation is an unfunded and unsecured promise to pay money in the future, such that the money or other property was not received at the time of the transfer and income is not required to be recognized until money or other property is received – i.e. when payments on the obligation are received. § 1.83-3(e) pertains to transfer of property to a Service Provider in connection with the performance of services. In a Notice 2003-47 transaction, the Service Provider sells or disposes of its option to a third party (arms length or not). The third party does not step into the shoes of the Service Recipient. Consequently, taxpayers' assertion that § 1.83-3(e) enables taxpayer to defer income by virtue of having received an unfunded and unsecured promissory note from the third party is without merit.

In Notice 2003-47 the Service responded that the transaction fails to generate the tax benefits claimed for several reasons, including: (1) the transfer of the stock options to a related person for a long-term unfunded, unsecured balloon obligation is not an arm's length transaction; and (2) in any event, the executive's receipt of the obligation is taxable currently.

In addition to Notice 2003-47, the Treasury issued Temporary Regulation § 1.83-7T, which applies to transactions occurring on or after July 2, 2003, which provide that for purposes of the "arm's length transaction" language of Treas. Reg. § 1.83-7(a), a transfer to a related person is not an arm's length transaction. For these purposes, a related person generally includes family entities. The final regulations published August 10, 2004 adopted the temporary regulations without change. 68 FR 48392 (August 10, 2004), and are effective prospectively to transfers of stock options occurring on or after July 2, 2003.

While the regulations are prospective, invocation of § 1.83-7T is not a requisite to the Service's ability to prevail on the non-arm's length issue in litigation. Rather, the courts decision will ultimately rest on whether the facts and circumstances support the taxpayer or government's position.

The related person typically takes the position that it receives basis in the option or restricted stock equal to the stated principal amount of the deferred payment obligation. In the case of an option, the related person receives further basis in the stock acquired upon exercise of the option equal to the exercise price paid for the stock. Thus, the related person generally claims a substantial basis in the stock when the stock is sold.

<u>ISSUE 1</u>

Is the sale between the taxpayer, executive and related party considered to be at arm's length for purposes of § 83?

COMPLIANCE'S POSITION

The Government argues that the transaction, as described in Notice 2003-47 and as promoted by some accounting firms is not an arm's length transaction under § 83.

TAXPAYER'S POSITION

The transaction was at arm's length and hence, further application of § 83 is not warranted when the options are exercised.

DISCUSSION AND ANALYSIS

The consequences of the sale hinges upon whether the transaction was at arm's length. If the transaction was at arm's length, the application of § 83 ends when the taxpayer disposes of the options.

Participants assert that the Code, Regulations, and legislative history of § 83 do not provide guidance on what constitutes an arm's length transaction. They opine that although the Courts have not addressed the specific issue, existing authority appears to recognize that an arm's length transaction is possible between related parties such that statutory and regulatory ambiguity exists as to whether a transaction between related parties may satisfy the arm's length standard.

Under the traditional definition of an arm's length transaction, a transaction must occur between unrelated parties. See Black's Law Dictionary 103 (7th Ed. 1999) (defining "arm's-length" as "of or relating to dealings between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power, not involving a confidential relationship"); Black's Law Dictionary 109 (6th Ed. 1990) (defining "arm's length transaction").[5] In some circumstances, however, courts have recognized that related parties may potentially act at arm's length. See Bank of New York v. U.S., 526 F.2d 1012 (3d Cir. 1975) (estate tax). However, even in those circumstances courts have stressed, transactions between family members are subject to special scrutiny. See, e.g., Harwood v. Commissioner, 82 T.C. 239 (1984), aff'd 786 F.2d 1174 (9th Cir. 1986), cert. denied, 479 U.S. 1007 (1986) (gift tax). Some courts have concluded that where the transaction involves a community of interests, such that the interests of the family members on one side of the transaction may coincide to some degree with the family members on the other side, the transaction is not considered to occur at arm's length. See Bank of New York v. U.S., 526 F.2d 1012 (3d Cir. 1975); Crème Manufacturing Co., Inc. v. U.S., 492 F.2d 515 (5th Cir. 1974) (excise tax).

The Court provided the following guidance in the Crème Manufacturing Co., Inc. decision:

> To be at arm's length, a transaction must be between parties with "adverse economic interests". Each party must be in a position to distinguish his economic interest from that of the other party and, where they conflict, always choose that to his individual benefit. Overlapping ownership and control are indicators that the parties may not be adverse. However, the absence of these factors does not automatically signal an arm's length transaction. It is the entire relationship between the parties that must be considered.

Thus in determining whether the transaction occurred at arm's length, the entirety of the transaction should be considered. If an independent third party would not have participated in the transaction in the manner in which the related parties participated, the parties did not act at arm's length.

---

[5] The Sixth Edition provides the following, potentially contradictory language:

> Said of a transaction negotiated by unrelated parties, each acting in his or her own self interest; the basis for a fair market value determination. A transaction in good faith in the ordinary course of business by parties with independent interests. Commonly applied in areas of taxation when there are dealings between related corporations, e.g., parent and subsidiary. The standard under which unrelated parties, each acting in his or her own best interest, would carry out a particular transaction. For example, if a corporation sells property to its sole shareholder for $10,000, in testing whether $10,000 is an "arm's length" price it must be ascertained for how much the corporation could have sold the property to a disinterested third party in a bargained transaction. (citation omitted)

A fact pattern where an executive transfers a valuable option or restricted stock for a long-term, unsecured obligation with a balloon payment schedule, and retains a large equity interest in an entity that has no operating business, and is funded predominantly by the very property which the executive transferred raises a question as to whether an arm's length transaction occurred.

Taxpayers generally argue that the transaction was at arm's length because the related person paid an amount equal to the FMV of the acquired property. Under such analysis, treatment as an arm's length transaction would rely solely on comparison of values, regardless of whether the entire facts and circumstances of the transaction reflected terms and conditions to which independent parties would have agreed on.

§ 83 does not discuss a sale at FMV, but rather whether a sale was at arm's length. Although the arm's length sale of property generally should result in a payment equal to the property's FMV, a mere payment equal to the stock option's purported FMV does not necessarily render a transaction an arm's length transaction for § 83 purposes. Taxpayers argue that in Bagley v. Comm. 85 T.C. 663 (1985), the court said that arm's length requirement is intended to assure that the statutory scheme is not circumvented by means of dispositions for less than the FMV. This is only one requirement; the term "arm's length transaction" for purposes of § 1.83-7 means something broader, incorporating examination of the entirety of the transaction, not just whether the FMV was paid.

§ 1.83-1(c) provides that the amount of compensation includible in the gross income of the transferor at the time of a non-arm's length disposition may not exceed the FMV of the property disposed of at the time of disposition, reduced by the amount paid for such property. Thus a transfer may be treated as non-arm's length disposition even if the transferor receives an amount equal to or exceeding the property's FMV at the time of disposition.

The § believes that many of these transactions fail to constitute a payment equal to the fair market value of the option. Under § 1.83-7(b)(3), the fair market value of an option is not merely the difference between the option's exercise price and the value of the property subject to the option, but also includes the value of the option privilege for the remainder of the exercise period. The option privilege, in the case of an option to buy, is the opportunity to benefit during the option's exercise period from any increase in the value of property subject to the option during such period, without risking any capital. Similarly, the option privilege in the case of an option to sell is the opportunity to benefit during the exercise period from a decrease in the value of property subject to the option.

It is believed that in the majority of Notice 2003-47 transactions, the options were valued at the difference between the exercise price and the fair market value of the stock at the time of the transaction. Had the transaction been between independent parties, however, the value of the options would have included the option privilege in the option value, as reflected in the Black-Scholes and similar valuation methodologies used to value options. Consequently, in those Notice 2003-47 transactions where the transfer price of the options does not include the option privilege, the transfer cannot be considered to have been at FMV and hence, certainly not an arm's length transfer under § 1.83-7(a).

Under the taxpayers' analysis, treatment as an arm's length transaction would rely solely on a comparison of values, regardless of whether the entire facts and circumstances of the transaction reflected terms and conditions to which independent parties would have agreed. In other words, despite the fact that the regulations fail to tax the option immediately upon grant because the option does not have a readily ascertainable fair market value, taxpayers argue that they should be allowed to reach that same result when the option is transferred to a related person based solely on the purported correct valuation of the option (which does not have a readily ascertainable value). The treatment of a transfer of a stock option as an arm's length transaction should not be read in such a manner as to render meaningless the readily ascertainable fair market value standard. Rather, the term "arm's length transaction" for purposes of § 1.83-7 means something broader, incorporating examination of the entirety of the transaction and not just whether fair market value was paid.

Finally, had the terms "arm's length" and "fair market value" been considered synonymous for § 83 purposes, § 83 and § 1.83-7 would reference the payment of the property's fair market value, a term used repeatedly in the statute and accompanying regulations, rather than requiring an arm's length transaction. See also Crème Manufacturing Co., Inc. v. U.S., 492 F.2d 515 (5th Cir. 1974) (distinguishing concepts of arm's length transaction and fair market price).

Taxpayers will point to certain decisions suggesting that for § 83 purposes, the payment of fair market value means the transaction is treated as an arm's length transaction. See Pagel, Inc. v. Commissioner, 91 T.C. 200 (1988), aff'd 905 F.2d 1190 (8th Cir. 1990) (sale of option by corporation service provider to sole shareholder); Bagely v. Commissioner, 85 T.C. 663 (1985) aff'd 806 F.2d 169 (8th Cir. 1986) (cashout of option); Rupprecht v. U.S., 11 Cl. Ct. 689 (Cl. Ct. 1987), aff'd without opinion, 829 F.2d 43 (Fed. Cir. 1987) (sale of option to entity purchasing corporation). However, none of these cases involved sales to family entities.[6] Furthermore, the analysis of the issue is minimal, § 1.83-1 is not cited or discussed, and the issue of whether the sale of an option should close the compensatory transaction was not contested.

Some executives have argued that § 7872 suggests that, as long as a loan provides for interest at or above the Applicable Federal Rate (AFR), it is treated as an arm's length transaction.[7] § 7872 addresses certain types of loans, including gift loans and compensation-related loans. § 7872 recharacterizes such loans if the loan is made at a below-market interest rate. Although § 7872 may be cited as supporting the notion that the interest rate charged may be another factor to strengthen the arm's length nature of the transaction for purposes of § 1.83-7, the fact that an obligation carries interest equal to or in excess of the AFR may not be dispositive of whether a transaction is "arm's length" as that term is used in § 1.83-7.

Similar arguments are made with respect to § 482, which generally addresses the authority of the IRS to allocate income and deductions among common controlled "organizations, trades, or businesses" to the extent necessary to reflect true taxable income. The regulations set forth a

---

[6]The Tax Court opinion in Weigl v. Commissioner, 84 T.C. 1192 (1985) applied the same fair market value standard to the transfer of an option by an employee to a family trust, although under pre-section 83 regulations. However, the opinion invites the Commissioner to notify the court and request a hearing if it disagrees with the arm's-length nature of the amount paid, indicating that this issue was not litigated. Furthermore, the central issues of the case involved whether the original transfer of the option to the employee's employer was in connection with the performance of services, and whether the family trust was a valid trust, and not whether the transfer from the employee to the trust was an arm's length transfer. Finally, given the court's finding that the proceeds from the trust's exercise of the option and sale of the stock two weeks later correlated with the valuation of the option, treatment of the transaction as non-arm's length would not have had much significance.

[7] Section 7872 only applies to bona fide loans.

broad framework of principles and methodologies for determining appropriate transfer prices for transfers of tangible and intangible property, the provision of services and interest on indebtedness. The overarching principle under the § 482 regulations is the arm's length standard, which in every case determines whether the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. See § 1.482-1(b). Whether this standard is met, in turn, generally is determined by reference to comparable transactions. Thus the primary emphasis under the § 482 regulations is to determine true taxable income generally by comparing the results in the controlled and uncontrolled transactions to determine whether the results in the controlled transaction reflect an arm's length result. If not, proper adjustments are made to such results so that they more accurately reflect an arm's length result.

Although taxpayers may argue that the § 482 regulations provide some support, the extensive framework of the § 482 regulations is not applicable for § 83 purposes. Indeed, the regimes work differently. In contrast to the § 482 regulations, the § 83 regulations focus on facts and circumstances but make no adjustments in an attempt to reach an arm's length result. Rather, the § 83 regulations simply provide for one consequence if the facts and circumstances of the transaction justify treatment as an arm's length transaction, and another consequence if the facts and circumstances of the transaction justify treatment as other than an arm's length transaction. Accordingly, the comparability framework set forth in the § 482 regulations is not relevant to the § 83 analysis.

Furthermore, depending on the specific facts and circumstances, a transaction described in Notice 2003-47 may not satisfy the standards set forth in § 482. Accordingly, any representation that the transaction would meet these standards should be questioned.

ISSUE 2

Is the unsecured, unfunded promissory note from the transferee (related party) considered property for purposes of § 83?

COMPLIANCE'S POSITION

The Government asserts that the receipt of a deferred payment obligation, such as a note, contractual agreement or annuity, at the time of the transfer constitutes property and results in immediate recognition of income under §§ 1.83-1 or 1.83-7.

The Government also argues that even if the obligation is not treated as property under § 83, the gain on the sale is compensation income that cannot be deferred by the executive.

TAXPAYER'S POSITION

Taxpayers argue that by virtue of the note being unfunded and unsecured, it's not considered property for purposes of § 83. Consequently, they assert that the income is not recognizable until the note is satisfied, resulting in a deferral typically of 15 to 30 years.

DISCUSSION AND ANALYSIS

As stated in Notice 2003-47, the Service's position is that the receipt of a deferred payment obligation, including an annuity, from a third party in exchange for a compensatory stock option or restricted stock results in immediate recognition of income. The executive recognizes income to the extent the amount of the deferred payment obligation transferred to the executive, plus any cash or other property received by the executive exceeds the amount, if any, the executive paid for the option or restricted stock. This position applies regardless of whether the transaction is treated as an arm's length transaction, or a non-arm's length transaction for purposes of § 1.83-1 or § 1.83-7. There are two bases for this position. First, the receipt of the obligation constitutes the receipt of property for purposes of §§ 1.83-1 and 1.83-7, resulting in application of §§ 83(a) and (b) and immediate inclusion of income. Moreover, even if the obligation were not treated as § 83 property, the Service's position is that the gain on the sale is compensation income that cannot be deferred by a cash basis taxpayer. See § 1.1001-1; § 1.83-7(a) (last sentence); § 15A.453-1(d)(2).

Treatment of Obligation as § 83 Property

§ 1.83-7(a) provides that "if an option is sold or otherwise disposed of in an arm's length transaction, §§ 83(a) and (b) apply to the transfer of money or other property received in the same manner as §§ 83(a) and (b) would have applied to the transfer of property pursuant to an exercise of the option." This language requires that the related person's deferred payment obligation be treated as a third-party obligation provided as compensation to the employee upon exercise of the option. Therefore, if the obligation is treated as § 83 property, the employee recognizes compensation income equal to the fair market value of the obligation less any amount paid for the original option (generally zero). Although § 1.83-7 does not expressly address arm's length transactions, by analogy to the § 1.83-1 regulations the same analysis should apply where a deferred payment obligation is provided as part of a non-arm's length transaction. Substantially similar rules apply to the receipt of money or property upon the transfer of substantially nonvested stock. See § 1.83-1.

The use of a third-party obligation to pay for services results in an economic benefit to the recipient, resulting in immediate inclusion in income. In essence, the third-party obligation is treated as property received. See U.S. v. Christine Oil & Gas Co., 269 Fed. 458 (W.D. La. 1920) ("If [the taxpayer] accepts the notes of third persons in absolute payment, the result would be different. But where the effect of the transaction is a mere promise to pay, it cannot be said to be income"); Walls v. Commissioner, 21 B.T.A. 1417 (1931), aff'd 60 F.2d 347 (10th Cir. 1932) (attorney assigned a 1/8 interest in an oil lease by client in exchange for services received property with a fair market value and includible in income when received).

This treatment of third-party obligations is demonstrated in Rev. Rul. 69-50, 1969-1 C.B. 140, amplified by Rev. Rul. 77-420, 1977-2 C.B. 172. In that ruling, the taxpayer physician performed medical services for individual patients pursuant to an agreement whereby the amounts were paid to the physician by a non-profit corporation. The physician was allowed to elect to defer a certain amount of the payment. The ruling finds that: "The participating physician's right to the compensation payments credited to his account by the corporation emanates from the medical services that he has rendered to patient-subscribers. Under the agreement the patient-subscribers have compensated the participating physician for these services by vesting him with such right. In effect, they have funded their obligation to the participating physician with the corporation, and, in so doing, they have conferred an economic or financial benefit on the participating physician." See also Rev. Rul. 77-420, 1977-2 C.B. 172 (extending Rev. Rul. 69-50 to require recognition of income even where the deferred payment obligation was subject to a substantial risk of forfeiture back to the non-profit corporation). Note that were the corporation the service provider to the patients, such that the physician was employed by or provided services to the corporation, the result would have been different.[8]

[8] Executives may point to the decision in Minor v. U.S., 772 F.2d 1472 (9th Cir. 1985), involving a similar arrangement. In a footnote, the court dismissed the Service's reliance on Rev. Rul. 69-50, characterizing the ruling as a constructive receipt ruling, rather than an economic benefit ruling. However, the court

Rev. Rul. 77-420 clarifies that the third-party obligation confers an economic benefit even if it is subject to substantial risk of forfeiture back to the third party, indicating that whether the third party promise is vested or nonvested is irrelevant. While these rulings do not deal with § 83, but rather the general economic benefit doctrine, there is no indication that § 83 or § 1.83-7 was intended to change this application of economic benefit rules, so the recipient of a third party obligation would still be required to recognize income at the time of the transfer.

Taxpayers argue that under § 1.83-7, the obligation is treated as that of the employer's obligation, and that a third-party obligation is not property for purposes of § 83. Essentially the Executive argues that he sold his options and he will recognize the compensation income when the FLP pays its outstanding debt.

Taxpayers most commonly rely upon the definition of property in the regulations accompanying § 83. § 1.83-3(e) defines property to exclude money or an unfunded and unsecured promise to pay money or property in the future. Executives argue that this definition is broad and intended to cover any unsecured deferred payment obligation, including third-party obligations. § 1.83-3(e) addresses property transferred in connection with the performance of services. It is our view that the provisions do not apply to transactions outside of this relationship.

The government asserts that the executive's interpretation of the regulation is not supported by the authorities concerning application of the constructive receipt or economic benefit doctrines. If an employee would be required to recognize compensation income upon the receipt of a third party obligation as a payment for services rendered, § 83 should not be read to alter this result. The language in § 1.83-3(e) mirrors the language of Rev. Rul. 60-31, 1960-1 C.B. 174, which provides the general rules governing application of the constructive receipt doctrine to deferred compensation arrangements. That ruling provides that a "mere promise to pay, not represented by notes or secured in any way, is not regarded as receipt of income within the intendment of the cash receipts and disbursements method." However, the ruling addresses only obligations relating to the agreement to perform services between a service recipient and a service provider, with no indication of an intent to cover any promise other than an unfunded, unsecured promise of the service recipient. See Rev. Rul. 69-50, discussed above, addressing third-party obligations.

Even if viewed as more expansive to cover a third party's promise to pay compensation, this exclusion from property would not cover a third party's promise to pay an employer an amount for noncompensatory purposes (for example, to purchase widgets), transferred by the employer to the employee as a compensation payment. For example, Rev. Rul. 69-474, 1969-2 C.B. 105, distinguished Rev. Rul. 69-50, finding no immediate income recognition where the physician-partners in a medical partnership performing services for a corporation were allowed to participate in the corporation's nonqualified deferred compensation plan. Because there was no contractual relationship between the partnership and the corporation, the ruling found no income

---

appears to have distinguished the facts of the case, stating that while the facts in Rev. Rul. 69-50 were similar, in the ruling "the physician had effectively obtained the income because his right to immediate compensation emanated from the medical services rendered to patients, independent of his voluntary agreement with the corporation to defer a percentage of payments otherwise due for those services." Similarly, the compensation in a Notice 2003-47 transaction emanates directly from the employer, independent of the employee's voluntary agreement with the related person.

flowing to the partnership from any interest in the plan. Rather, the corporation's obligation under the plan was treated as the corporation's unfunded, unsecured promise to pay the physician. But the corporation's promise constituted a direct promise to pay from the corporation to the service-providing physician for services provided to the corporation, and was not used as payment by the partnership for the physician's services. In contrast, as provided in § 1.83-7, the related person's obligation to purchase the stock is viewed as replacing the employer's original obligation to transfer the underlying stock, and not as a payment for any services provided to the related person.

§ 1.83-3(e) defines property, for purposes of § 83, as real and personal property other than either money or an unfunded/unsecured promise to pay money or property in the future. The regulations continues and it provides that the term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example in a trust or escrow account. Once again, this is to be read in the intended context of the relationship between the employer and employee.

The taxpayers argue that § 83 does not define or offer any further guidance on what constitutes an unsecured and unfunded promise to pay. The regulations imply that the obligation must be vested and either funded or secured to be property. That is true. An obligation by an employer to an employee for performance of service should be vested, funded and secured to be recognized as income by the employee. However, that exclusion from the definition of property does not apply to a sale of stock options by the executive, which does not stem from the employer-employee relationship or in connection with the performance of services.

§ 1.83-3(e) defines property to exclude an unfunded and unsecured promise to pay money or property in the future. § 83 deals with the transfer of property <u>in connection with the performance of services</u>.

When § 1.83-7(a) discusses the taxation that will result when the "option is sold or otherwise disposed of," the "money or 'other property`" paid for the option is not transferred in connection with the performance of services by a third party interested in the services being rendered, but instead is paying for the option. At this point the question is what amount is realized on the sale, just as is the case when restricted property is sold (see § 1.83-(b)), and not whether "property" is transferred in connection with the performance of service. The definition of property is applicable to § 83 and property transferred in connection with the performance of services. If the definition of "property" in § 1.83-3(e) is applied to the "other property" in an option disposition transaction described in § 1.83-7, the provision becomes unadministrable. Thus there is support for the conclusion that the reference to an unfunded and unsecured promise to pay refers solely to promises by the service recipient, or by persons (such as parent corporations or shareholders) in connection with the performance of services and not to those promises issued by purchasers of options or restricted stock.

The sale of an option for an unsecured and unfunded note does not change the results, because the definition of property under § 1.83-3(e) is not applicable. The definition states that it is the definition of property for § 83 purposes and the regulations thereunder. § 83 deals with transfer of property in connection with the performance of services. § 1.83-7, however, addresses more specifically with a sale of options wherein the option seller, like any seller of property, can receive only two forms of consideration – money or "other property." Those forms of consideration are taxed in the same manner as would be the exercise of the option.

Taxpayers may cite the Tax Court's decision in Childs v. Commissioner, 103 T.C. 634 (1994), aff'd without op. 89 F.3d 856 (11th Cir. 1996), as providing that third party obligations are not treated as property for § 83 purposes. This case did not deal with the sale of an option, rather it involved a structured settlement providing for the payment of attorneys' fees. The plaintiffs' attorneys had agreed to a contingent fee arrangement, which is unlike an unsecured and unfunded note. When the parties entered into a settlement agreement, the defendant agreed to pay the attorneys their portion of the fees directly, and to purchase an annuity to provide the payment. The court stated that the attorneys were not in constructive receipt because the agreement was reached before the payment was offered. The court then analyzed whether the annuity funded the defendant's obligation to pay the attorneys and, if so, was property under § 83. Executives argue that this should be read to provide that third party obligations are not property for § 83 purposes. However, the court failed to address whether the attorneys had already received property because the plaintiff (service recipient) had paid for the attorneys' services by giving the attorneys the defendants' promise to pay.[9]

Furthermore, the case involves a structured settlement in which the service provider's compensation was contingent upon and to stemmed directly from the payment by the third party. In essence, the service recipient (the plaintiff) established a portion of its own funds (the potential settlement) as the only source from which the service provider would be paid. Although technically the service provider received a promise from the third party (the defendant), the service provider in substance continued to possess an unsecured interest in a portion of the service recipient's funds (the potential settlement which otherwise would have been paid to the service recipient), which would not be available until the settlement was paid. So, for example, the decision may mean that an employee who was promised a commission on a sale if and when the customer paid, which instead of being paid to the employer and then forwarded to the employee would be paid directly by the customer to the employee when the product was purchased, would not be deemed to have received property if the employee received only the customer's unsecured promise to pay. In contrast, the decision does not address situations such as a Notice 2003-47 transaction where a third party obligation is treated as a payment by the service recipient for services unrelated to the issuance of the obligation, without any prearrangement between all the parties. Accordingly, the decision does not address whether under those circumstances the obligation would be viewed as § 83 property.

Treatment as a Sale or Exchange of Property

The second basis for the Service's position is that the provisions governing transfers of options contained in § 1.83-7 were not intended to alter the treatment of the transfer of the option or restricted stock as a sale or exchange of property. Rather, the application of § 83 only confirms that the gain is treated as compensation income.

Prior to the enactment of § 83 and the regulations thereunder, § 1.421-6 provided rules governing the treatment of compensatory options that lacked a readily ascertainable fair market

[9] Some commentators have noted that the court may have failed to address the correct issue. See Polsky, Gregg D., "A Correct Analysis of the Tax Treatment of Contingent Attorney's Fee Arrangements: Enough with the Fruits and the Trees", 37 Ga. L. Rev. 57, 96-102 (2002); Gordon T. Butler, "Economic Benefit: Formulating a Workable Theory of Income Recognition", 27 Seton Hall L. Rev. 70, 119-120 (1996); see also 740 T.M. Accounting Methods - General Principles, at A-64 & n. 764 (rule that cash-method taxpayer recognizes income from receipt of third party note "dates from the dawn of federal tax law").

value at the date of grant. The regulations provided that the options were not taxed at grant. The regulations provided further that when such an option "is transferred in an arm's length transaction, the employee realized compensation in the amount of the gain resulting from such transfer of the option, and such compensation is includible in his gross income in accordance with his method of accounting."

The enactment of § 83 was not intended to change this treatment. The differences between the § 1.421-6 regulations and its successor regulations at § 1.83-7 with respect to the sale or disposition of options were intended only to bring the transaction within the framework of § 83, and to insure that any gain recognized by the service recipient was includible under § 83(a) or (b) so that the service recipient could deduct under § 83(h), even though the consideration received on the sale may not be provided by the service recipient. Once brought within § 83, the recognizable gain on the transaction must be recognized unless the amount realized upon the sale or exchange is substantially nonvested.

A transfer of options by the service provider in exchange for the deferred payment obligation is a "sale or disposition" within the meaning of § 1001(a). Under current law, the gain upon the sale or disposition of property in exchange for a deferred payment obligation generally must be recognized immediately, unless installment reporting applies. See § 1001(c); § 15A.453-1(d)(2)(i) ("Receipt of an installment obligation [in an installment sale] shall be treated as a receipt of property, in an amount equal to the FMV of the installment obligation … whether or not such obligation is the equivalent of cash"). Under § 1001(a), the gain equals the excess of the amount realized over the adjusted basis. As a general rule, the amount realized upon a sale or other disposition of property is the sum of the cash and the FMV of any other property received. See § 1001(b). For certain deferred payment obligations issued in exchange for property, § 1.1001-1(g) provides rules to determine the amount realized. In general, the issue price of the obligation, including a deferred payment obligation resulting from a sales contract, determines the amount realized.

In Lucas v. Earl, 281 U.S. 111(1930), the United States Supreme Court said that income must be taxed to the person who earns it, and may not be avoided by assignment to another. The Court explained that the tax cannot be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it.

Similarly, a taxpayer may not avoid taxation on his/her compensation income by entering into steps and formalities to stall income recognition for several years (i.e. 15 to 30 years). To the contrary, § 83 accelerates the timing of the compensation income when the taxpayer sells or otherwise disposes of the rights. Had the taxpayer not entered into the elaborate steps to dispose of the stock options before exercise, he/she would have deferred income recognition until the time of exercise.

Accordingly, the transfer of the option or restricted stock in return for a deferred payment obligation results in recognizable gain generally equal to the issue price of the obligation less any adjusted basis in the option (typically zero), unless installment reporting applies. Brought within the § 83 framework and the application of §§ 83(a) and (b), this recognizable gain is taxable immediately as compensation income unless substantially nonvested. Because the transaction results in compensation income, the installment method of reporting under § 453 is not available. See Sorensen v. Commissioner, 22 T.C. 321 (1954). § 1.83-7 should be read to apply § 83 to the amount received upon the sale in the same manner as § 83 would have applied to the transfer of property upon exercise of the option. See Realty Loan Corp. v.

Commissioner, 54 T.C. 1083 (1970), aff'd, 478 F.2d 1049 (9th Cir. 1973) (citing Sorensen v. Commissioner, 22 T.C. 321 (1954) as providing that the sale of a compensatory option for a note "could not change the nature of that for which it was substituted or the time at which the amount was includible in income"). Accordingly, the recognizable gain on the transaction must be recognized unless the amount realized upon the sale or exchange is substantially nonvested.

Although the executive may cite Mitchell v. Commissioner, 65 T.C. 1099 (1976), aff'd. 590 F.2d 312 (9th Cir. 1979) as providing otherwise, the Mitchell decision centers on the characterization of the payments as compensation income rather than capital gain, and does not fully develop the timing issue or discuss the application of § 453-Installment Method sale and its exceptions.

Executives participating in Notice 2003-47 transactions involving private annuities generally will cite Rev. Rul. 69-74, 1969-1 C.B. 43, as authority for deferring recognition of compensation income at the time of the transfer. There, one issue was whether "gain" was realized on appreciated property when a taxpayer used that property to purchase a private annuity. Rev. Rul. 69-74 would not apply to determine whether and when a taxpayer received gross income in connection with the performance of services under § 83. Rather, consistent with the principles applied in Sorenson denying installment reporting treatment to sales or dispositions of property resulting in compensation income, the Service should argue that the deferred recognition of income upon receipt of an annuity pursuant to § 72 is not applicable to sale or exchange transactions resulting in compensation income.

ISSUE 3

The Application of the Anti-Abuse Rule

COMPLIANCE'S POSITION

The Government argues that the transaction may be recast for federal tax purposes under § 1.701-2 to achieve results that are consistent with the intent of Subchapter K, in light of the applicable and regulatory provisions and pertinent facts and circumstances.

TAXPAYER'S POSITION

Taxpayers argue that the transaction was a valid sale at arm's length and it is inappropriate for the Service to invoke the partnership anti-abuse provisions of § 1.701-2.

DISCUSSION AND ANALYSIS

Compliance argues that the transaction may be recast for federal tax purposes under § 1.701-2 to achieve results that are consistent with the intent of Subchapter K, in light of the applicable and regulatory provisions and pertinent facts and circumstances.

The ability of the Service to recast transactions under the partnership anti-abuse rule is dependent on the facts and circumstances of each case. Development of the issue must be thorough and complete.

In order to recast a transaction under the partnership anti-abuse rule, a principal purpose of the transaction must have been to substantially reduce the present value of the partners' aggregate federal tax liability and this reduction must be inconsistent with the intent of Subchapter K.

Compliance relies on § 1.701-2(b) for its authority to recast the transaction at issue. Whether a partnership was formed or availed of with a principle purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of Subchapter K is determined based on all the facts and circumstances. § 1.701-2(c) lists various factors indicative of whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of Subchapter K. The presence or absence of any factor described in § 1.701-2(c) does not create a presumption that a partnership was (or was not) used in such a manner.

§ 1.701-2(a), the partnership anti-abuse rule, provides in pertinent part that Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of Subchapter K are the following requirements:

> (1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose;
>
> (2) The form of each partnership transaction must be respected under substance over form principles; and
>
> (3) Except as otherwise provided, the tax consequences under Subchapter K to each partner of the partnership operations and of transactions between the partnership and the partner must accurately reflect the partners' economic agreement and clearly reflect the partner's income.

§ 1.701-2(b) provides that the provisions of Subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of Subchapter K as set forth in § 1.701-2(a). Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, the Service can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the intent of Subchapter K in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Service can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of Subchapter K: (1) the purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners; (2) one or more of the purported partners of the partnership should not be treated as a partner; (3) the methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income; (4) the partnership's items of income, gain, loss, deduction or credit should be reallocated; or (5) the claimed tax treatment should otherwise be adjusted or modified.

§ 1.701-2(c) provides that whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of Subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. § 1.701-2(c) lists factors that may be considered in making the determination but those factors do not create a presumption that a partnership was or was not used in a manner inconsistent with Subchapter K.

One of the factors on the list indicative of a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of Subchapter K is that the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership assets and conducted the partnership's activities directly. See § 1.701-2(c)(1). Assuming that the executive's arguments with respect to the amount and timing of compensation income recognition in a Notice 2003-47 transaction were valid, the present value of the partners' aggregate federal tax liability would be much greater if the executive who held the compensatory stock option retained individual ownership of the stock option and then carried out the activity of the partnership by exercising the option directly, because the executive would have to recognize the compensation income immediately upon exercise of the option. This is true whether the partnership was formed for the purpose of engaging in this transaction or an existing partnership was used to engage in the transaction. Another factor on the list is that one or more partners who are necessary to achieve the claimed tax results have a nominal interest in the partnership. See § 1.701-2(c)(3). In many of the Notice 2003-47 transactions, the partners other than the individual holding the compensatory stock option have very minor interests in the partnership. A third factor indicative of intent is that substantially all of the partners are related (directly or indirectly) to one another. See § 1.701-2(c)(4). A fourth factor is that the benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the individual (or a related party). See § 1.701-2(c)(6). In these transactions, the executive's family members are usually the other partners in the partnership, thereby maintaining control of the property within the executive's family.

The Service believes that a partnership formed or availed of in connection with a Notice 2003-47 transaction does not operate in a manner consistent with the intent of subchapter K. In the Notice 2003-47 transactions, the requirement that each partnership be bona fide and that each partnership transaction or series of related transactions be entered into with a substantial business purpose is not met. A partnership formed or availed of in connection with this transaction often engages in a minimal amount of investment transactions to generate the appearance of a business purpose in the event the transaction is challenged. Other than these minimal investment activities, the partnership may engage in no other business activity. The real purpose of the partnership is the delay or avoidance of the recognition of compensation income and gain through the Notice 2003-47 transaction. Although establishment of substantial business purpose is a fact-specific inquiry, the reasonably expected pre-tax profit from the investment transactions is minimal when compared to the purported avoidance of tax liability achieved through this transaction.

Courts have found that, despite following all the formalities for creating a partnership, the alleged partners' conduct and relationship was such that a bona fide partnership did not exist. Merryman v. Commissioner, 873 F.2d 879 (5th Cir. 1989), aff'g, T.C. Memo. 1988-72; ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000), aff'g, T.C. Memo 1998-305, cert. denied, 531 U.S. 871 (2000).

In Merryman, the court disregarded a partnership that lacked economic substance and served no purpose other than to create tax benefits for its partners. The partnership consisted of the key employees and officers of the company, the company itself acting as managing partner, and another partnership consisting of the shareholders of the company who were all members of a single family. Formation of the partnership allowed the company to retain control of a major asset, an oil rig, while passing along various tax advantages to the partners. On the day of the partnership's formation, the partnership purchased the oil rig from the company and simultaneously surrendered control of the rig back to the company. Despite all appearances that the company, as managing partner, had control of the partnership's affairs, in actuality one of the partners, who was also the president and chairman of the company, made the ultimate decisions. The only partner who paid the required capital contribution to the partnership was the company. The partnership, which purchased the oil rig apparently for fair market value, was not required to make a down payment; a promissory note was accepted. The court noted, "This sale by the managing partner on exceedingly favorable terms to the partnership raises doubts about the existence of an arms-length deal and provides evidence of a transaction lacking economic substance. Here, in fact, [the company] became both mortgagee and co-mortgagor on the note." (Internal citations omitted).

Many of the facts described in the Merryman case are relevant to a determination of whether a bona fide partnership and transactions with a substantial business purpose exist. With regard to the transfer of the stock options or restricted stock in the Notice 2003-47 transactions, some considerations should include (but not be limited to) whether the executive was the only partner who contributed to the partnership, whether there was any real change in control from executive to partnership of the stock options or restricted stock, whether any of the other partners are tax neutral, whether the partners complied with the terms of the partnership agreement, and whether there was any business purpose or profit motive for creating and maintaining the partnership.

The second requirement of the anti-abuse rule in § 1.701-2(a) that the form of each partnership transaction must be respected under substance over form principles is not met in a Notice 2003-47 transaction. It is axiomatic that the substance rather than the form of a transaction governs the federal income tax treatment of the transaction. 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). Even if the transaction does comply with the requirements under the Code, transactions that literally comply with the language of the Code but produce results other than what the Code and regulations intended are not given effect. In Gregory v. Helvering, 293 U.S. 465, 470 (1935), the Supreme Court found that even though the transaction complied with the Code, "the transaction upon its face lies outside the plain intent of the statute." Therefore, the Court found that to give the transaction effect would be to "exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Id. In Knetsch v. United States, 364 U.S. 361 (1960), the Supreme Court once again found a transaction abusive, even though the transaction met every literal requirement of the Code. The Court stated that "there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction." Id. at 366. A transaction that is entered into solely for the purpose of tax reduction and that has no economic or commercial objective to support it is a sham and is without effect for federal income tax purposes. Estate of Franklin v. Commissioner, 64 T.C. 752 (1975); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985); Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Nicole Rose Corp. v. Commissioner, 117 T.C. 27 (2001).

In the majority of the Notice 2003-47 transactions, given the relationships between the parties, it is likely that the facts will reveal that the substance of the transaction is that the executive exercises the compensatory stock options or transfers the restricted stock and effectively retains control over the proceeds.

The form of the transaction makes it appear that the exercise of the options is carried out by a separate party and that individuals other than the executive have control of the proceeds. The form does not reflect the substance of the transaction. Moreover, there was nothing of substance to be realized from the transaction aside from the avoidance of tax. An anti-abuse rule challenge under the substance over form principles should include (but not be limited to) the following: the close relationship of the partners, the almost immediate exercise of the options by the related party, retention of the benefits and burdens of the options and acquired stock by the executive/partner, the creation of the partnership in order to engage in this transaction, the transaction causing the executive/partner's federal tax liability to be substantially less than had the executive/partner owned the partnership's assets and conducted the partnership's activities directly, and a determination that the partnership does not engage in other substantial activities.

§ 1.701-2(b) gives the Service broad authority to recast a transaction or series of transactions in the event that a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K. In light of this, the partnership anti-abuse rule should be applied to disregard the partnership or some of the partners or to disregard the purchase of the compensatory stock options or restricted stock by the partnership, depending on the particular facts of the transaction.

If a partnership is formed in connection with a Notice 2003-47 transaction, the Service may disregard the partnership and recast the transaction in a manner that is consistent with the partners engaging in the activities directly. This approach will eliminate the delay or avoidance of compensation income and gain recognition. Other authorities support the Service's disregard of the purported Partnership. Under § 761, a partnership includes "a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate." See also § 7701(a)(2). The Supreme Court in Commissioner v. Culbertson, 337 U.S. 733, 742 (1949), stated that a partnership is created for federal income tax purposes if:

> [C]onsidering all the facts -- the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent – the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

The Tax Court in Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964), set forth the following nonexclusive list of factors relevant to the consideration of whether a partnership is created:

> The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party had made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to

> share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over the assumed mutual responsibilities for the enterprise.

In ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000), aff'g, T.C. Memo 1998-305, cert. denied, 531 U.S. 871 (2000), the Court of Appeals for the D.C. Circuit found that a partnership formed for a tax purpose and which engages in de minimis business activity in furtherance of that tax purpose is not a valid partnership. ASA, 201 F.3d at 512; see also Boca Investerings Partnership v. United States, 314 F.3d 625 (D.C. Cir. 2003). Moreover, the ASA court stated that whether "the 'sham' be in the entity or the transaction . . . the absence of a nontax business purpose is fatal." ASA, 201 F.3d at 512.

Applying this analysis to the facts before it, the Court of Appeals in ASA found that even though the "investment in LIBOR Notes might have had a business purpose, the prior three-week investment in and subsequent sale of the private placement Notes (PPNs) was . . . a business activity merely conducted for tax purposes." Id. at 513. The Court of Appeals realized that the taxpayer may have had an interest in potential gain from its investments, but those interests were "dwarfed by its interest in the tax benefit." Id. at 513. In concluding that ASA Investerings was not a legitimate partnership, the court further clarified that "[a]lthough a taxpayer may structure a transaction so that it satisfies the formal requirements of the Internal Revenue Code, the Commissioner may deny legal effect to a transaction if its sole purpose is to evade taxation." Id. (quoting Zmuda v. Commissioner, 731 F.2d 1417, 1421 (9th Cir. 1984)). Hence, the standard in the D.C. Circuit is that a de minimis business purpose will not validate a partnership whose true purpose is the pursuit of tax benefits. Rather, the relevant legal inquiry, as found by the Court of Appeals for the D.C. Circuit, is a comparison of the purported business purpose to the expected tax benefit. Id. at 513. The weight placed upon this legal factor led the D.C. Circuit to disregard the partnership entity. Id. at 516.

On the issue of risk, the D.C. Circuit Court of Appeals in ASA allowed for the existence of de minimis risk in the transaction noting that "no investment is entirely without risk." Id. at 514. The court further concluded that a carve out of de minimis risk is consistent with the Supreme Court's view that "a transaction will be disregarded if it did 'not appreciably affect [taxpayer's] beneficial interest except to reduce his tax.'" Id. (quoting Knetsch v. United States, 364 U.S. 361, 366 (1960)).

As with the transactions in ASA and Boca, it is possible that de minimis risk exists in the Notice 2003-47 transactions. The partnership will bear some risk of loss if the options are not exercised shortly following the sale from the executive; however in most cases, the options were exercised quickly after the sale. According to the factual development thus far, the minor investment activities engaged in by many of the partnerships are de minimis compared to the amount of the claimed tax savings. As such the Service argues that the modicum of business purpose asserted by the executives for the formation of the partnership in a Notice 2003-47 transaction does not alter the fact that the true purpose for the partnership is the reduction of tax liability. Thus, it's the Service's position that the partnership entity should be disregarded.

As noted in the CIP, in cases in which an operating partnership engages in a Notice 2003-47 transaction, it may not be appropriate to disregard the partnership. In these cases, § 1.701-2 applies to permit the Service to recast the transaction in a manner consistent with the intent of Subchapter K. A Notice 2003-47 transaction, whether engaged in through a partnership formed primarily for use in the transaction or through a previously operating partnership, reduces substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of Subchapter K. The fact that such reduction was a principal purpose of engaging in the transaction is apparent from the lack of legitimate economic purpose for the transaction. A comparison of the tax gain generated by the transaction to the economic benefit that the transaction could be reasonably expected to generate is a significant factor indicating that the principal, if not sole, purpose for engaging in a Notice 2003-47 transaction is the tax delay or avoidance generated by the transaction.

It follows from this that the Service may recast the transaction by, among other things, disregarding the purchase of the compensatory stock options or restricted stock by the partnership. If the purchase is disregarded, the purported delay or avoidance of compensation income and gain recognition generated by the Notice 2003-47 transaction will be eliminated.

ISSUE 4

Judicial Doctrines

COMPLIANCE'S POSITION

The Government argues that under appropriate facts and circumstances, the transaction may be challenged under Judicial Doctrines, including, but not limited to, the economic substance, sham transaction and step transaction doctrines.

TAXPAYER'S POSITION

The taxpayers argue that the FLP should be respected and that the sale is a valid transaction between two separate taxable entities. They argue that the parties created the FLP with the intention of making a profit, their agreements and conduct support their intention and the FLP has been sufficiently capitalized to engage in investments. It is not a mere shell.

Taxpayers also assert that the sale should be respected as a bona fide sale between separate taxable entities, citing the decision of the Supreme Court in Frank Lyon V. U.S. 435 U.S. 561 (1978). In that decision, the Supreme Court commented on the substance over form principle. The Court looked at the objective economic realities of the transaction, rather than the particular form the parties' employed. The Court has never regarded the "simple expedient drawing up of papers," as controlling for tax purposes when the objective economic realities are to the contrary. In the field of taxation, administrators of the laws and the Courts are concerned with substance and realities, and formal rigid documents are not rigidly binding. Nor is the parties desire to achieve a particular tax result necessarily relevant. The taxpayers' argument is that the transaction has objective economic realities and not mere formalities.

Taxpayers argue that several provisions in the Code recognize that sales between related parties may be valid transactions.

DISCUSSION AND ANALYSIS

There are numerous judicial doctrines used to analyze the true nature of a transaction and determine whether it has any business function or can be disregarded because it is solely driven by a tax purpose. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935). Economic substance, sham 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 these 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. Use of the judicial doctrines would have the effect of forcing the executive to report the income in the year the options were exercised rather than allowing the deferral of income to the year the balloon payment on the obligation is paid.

Lack of Economic Substance

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 to support it is without effect for federal income tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935); Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g sub nom. Glass v. Commissioner, 87 T.C. 1087 (1986); ACM Partnership v. Commissioner, 157 F.3d 231, 246-247 (3d Cir. 1998), aff'g in part and rev'g in part, T.C. Memo. 1997-115, cert. denied, 526 U.S. 1017 (1999); United States v. Wexler, 31 F.3d 117, 122, 124 (3d Cir. 1994), cert. denied, 513 U.S. 1190 (1995); Goldstein v. Commissioner, 364 F. 2d 734, 740-741 (2d Cir. 1966), aff'g 44 T.C. 284 (1965), cert. denied, 385 U.S. 1005 (1967).

The lack of economic substance hinges on all of the facts and circumstances surrounding the transaction. No single factor will be determinative. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). 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 ACM Partnership v. Commissioner, supra; Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990), aff'g sub nom. Sturm v. Commissioner, T.C. Memo. 1987-625; Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254 (1999), aff'd 254 F.3d 1313 (11th Cir. 2001).

An evaluation of whether these stock option transactions lack economic substance requires separate, but interrelated, inquiries: (1) a subjective inquiry into whether the transaction was carried out for a valid business purpose; and (2) an inquiry into the objective economic effect of the transaction. ACM Partnership, 157 F.3d at 247-248; Casebeer, 909 F. 2d at 1363; Kirchman v. Commissioner, 862 F.2d 1486, 1490, 1491 (11th Cir. 1989).

To satisfy the business purpose inquiry, the transaction must be "rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and . . . economic situation." ACM Partnership, T.C. Memo. 1997-115, aff'd. in relevant part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999); See Kirchman, supra, at 1490-1491. A valid entity will be disregarded if its creation is nothing more than an artificial device to obtain a tax benefit. Gregory v. Helvering, 293 U.S. 465 (1935).

To satisfy the objective economic inquiry, the transaction must appreciably affect the taxpayer's beneficial interest, absent tax benefits. Knetsch v. United States, 364 U.S. 361, 366 (1960); ACM Partnership, 157 F.3d at 248. Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. See Knetsch, supra. 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). In conducting this economic review, it is appropriate to focus on the taxpayer's calculations at the outset of the transaction. ACM Partnership, 157 F.3d at 257.

In conducting these inquiries into the taxpayer's business purpose and beneficial interest, it is not determinative whether a controlling statute requires such inquiry. Rather, the issue is whether Congress intended to sanction a particular transaction regardless of its economic substance. Saba Partnership v. Commissioner, T.C. Memo. 1999-359. DeMartino v. Commissioner, 862 F.2d 400 (2d Cir. 1988); See Knetsch v. United States, 364 U.S. 361, 369 (1960).

In ACM Partnership, T.C. Memo. 1997-115, the Tax Court found that the taxpayer wanted 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. The Tax Court further stated that the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. It held that the transactions lacked economic substance and, therefore, the taxpayer was not entitled to the claimed deductions. Id. The opinion demonstrates that the Tax Court will disregard a series of otherwise legitimate transactions where the Service is able to show that the facts, when viewed as a whole, have no economic substance.

In Long Term Capital Holdings, et. al. v. U. S., Dkt. No. 3:01cv1290 (JBA) Doc 2004-17390 (U. S. District Court for the District of Connecticut), the Court found that the taxpayer's lease stripping transaction lacked economic substance, since prudent investors would not have incurred expenses in excess of any reasonably expected gain. The Court rejected the taxpayer's reliance on United Parcel Serv. of Am. v. Commissioner, 254 F. 3d 1014, (11th Cir. 2001). In UPS, the 11th Circuit determined that an internal restructuring did have a business purpose, whereas in Long Term Capital Holdings, the investment was a one-time purchase of a tax product by the taxpayer and was different from its regular business.

In Nicole Rose Corp. v. Commissioner, 117 T.C. 328 (2001), the Tax Court found that the purpose of the taxpayer's transfers of interests in computer equipment leases was to create substantial tax deductions. The Court noted that prior to the transactions, the taxpayer was not an ongoing business, that it never had any genuine obligation with respect to the leasebacks, that the interests creating the tax deduction were held less than a day, and that the transactions merely created a circular flow of funds with respect to the lender of the funds. The large deductions offset any tax cost associated with the transactions. Because the claimed tax benefits provided the only credible explanation for the taxpayer's actions, the Court held that the transactions lacked a business purpose and economic substance.

In the majority of the transactions under Notice 2003-47, the facts show that the compensatory stock option transactions promoted lack economic substance. In such transactions, the executive generally is the sole person who contributes significant amounts to the FLP and the FLP generally conducts minimal reinvestment activities. There is no true business purpose for creating the FLP. In the majority of cases the facts will reveal that the executive retained ownership and control of the options or the stock transferred to the FLP.

In the majority of these transactions, the FLP is created to purchase the options. There is no true business purpose for its creation. The executive was the owner of the options prior to the creation of the entity and retained ownership and control through his entity interest and that of close family relations. The obligation is unfunded and nonrecourse and may likely be abandoned over time. The economic effect of the transaction is to enable the executive to recognize a relatively minimal amount of interest income received from the obligation, defer the larger amount he would have reported upon exercise and sale of the options, and obtain the flow through deduction of the related entity's interest payment.

A finding that there is no economic substance to the transactions depends on facts and circumstances developed during the audit. If it is determined that the transaction lacks economic substance the executive would be required to report the compensatory income upon the exercise of the options on his individual return in the year the options were exercised.

In some transactions, the transfer may have been made to a well established FLP. The facts and circumstances should be fully developed as this may have an impact on the determination of whether the transaction was conducted at arm's length or not which may have an impact on the timing of recognition of compensation income under § 83. However, a sale to an established FLP does not necessarily mean that the transaction is conducted at arm's length. The entirety of the transaction should be considered and the determination should be made after full consideration of all facts and circumstances involved.

Substance over Form and Sham Transaction Doctrines

A transaction, which exalts substance over form solely to obtain tax benefits, will not be recognized. Although the form of a transaction may comply with the Internal Revenue Code, it will not be given effect where it has no business purpose and operates as a device to conceal the true character of a transaction. Andantech v. Commissioner, T.C. Memo. 2002-97, aff'd in part and remanded in part, 331 F.3d 972 (D.C. Cir. 2003). "A transaction is a sham if it is fictitious or if it has no business purpose or economic effect other than the creation of tax deductions. DeMartino v. Commissioner, 862 F.2d 400 (2d Cir. 1988). Courts will not construe a statute to permit sham transactions. Knetsch v. United States, 364 U.S. 361 (1960); United States v. Wexler, 31 F.3d 117 (3rd Cir. 1994), cert. denied, 513 U.S. 1190 (1995)(A sham transaction will not be recognized and, therefore, cannot be the basis for a deduction). A transaction that fails to create a genuine obligation would "…exalt artifice above reality and … deprive the statutory provision in question of all serious purpose." Gregory v. Helvering, 293 U.S. 465, 470 (1935).

In Goldstein v. Commissioner, the taxpayer borrowed funds at a 4% interest rate to purchase assets with a return rate of less than 2%. The court found that the loans were not shams due to their recourse nature and the fact that the funds were borrowed at arm's length from independent financial institutions. However, the court went on to find that the transactions lacked economic substance because of their unfavorable interest rate and anticipated economic loss. The court, therefore, disallowed the interest deductions created by the loans. 364 F.2d 734 (2d Cir. 1966).

In a Notice 2003-47 transaction, the partnership was created to give the appearance of a third party transaction in order to take advantage of a tax shelter. This shelter relied on an improper interpretation of § 83. The sale of the option by the taxpayer has no economic substance or business purpose. The taxpayer had control and beneficial interest in the FLP as per § 707(b)(1)(A).

In Sheldon v. Commissioner (94F. 2d. 724, 8th Cir 1990) the court focused on two factors to determine whether a transaction is devoid of economic substance for tax purposes, one of which is whether the transaction's reasonably expected economic benefits are insignificant relative to the reasonably expected tax benefits. In such a case, the transaction is disregarded. The taxpayer, in the majority of the transactions under Notice 2003-47 had no economic benefits from the sale of the options to the related entity, other than to avoid inclusion in income.

Step Transaction Doctrine

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; namely, (1) if at the time the first step was entered into, there was a binding commitment to undertake the later step (binding commitment test),[10] (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 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, supra.

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.

[10] 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).

True v. United States, 190 F.3d 1165, 1177 (10th Cir. 1999). See also Associated Wholesale Grocers v. United States, 927 F.2d 1517 (1991).

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 United States taxes. Del Commercial Props., Inc. v. Commissioner, 251 F.3d 210, 213-214 (D.C. Cir. 2001), aff''g T.C. Memo. 1999-411, cert. denied, 534 U.S. 1104 (2002); See also Penrod v. Commissioner, supra 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, 176 Ct. Cl. 244; 361 F.2d 972, 978 (1966)).

In determining whether to apply the step transaction doctrine, look to whether the interdependence test and/or end result test could be used to disregard the related person and treat the stock options as having been exercised and sold by the executive directly. This argument will depend on the particular facts of the case. To direct a challenge under the step transaction doctrine some considerations should include (but not be limited to) the following: whether only the executive's assets were used to fund the related person or whether there were other investors, whether the executive was the only individual who could benefit or lose from the transactions, whether there was any business justification to having the related person act as an intermediary for the exercise and sale of the options.

One needs to review the description of the "Technique" by promoters and the opinions provided to see how this transaction was intended to be accomplished. It began with the creation of the FLP and the ownership percentages recommended. This is then followed by the sale of the options in exchange for a long-term promissory note that is unfunded and unsecured, then the exercise of the options by the FLP and the sale of the stock. All the steps are designed to reach a goal of deferral of compensation while having access and control over such compensation. The end result of the transaction is the deferral of compensation. The interdependence test may also apply.

In determining whether to apply the step transaction doctrine, one needs to look to whether the interdependence test and/or end result test could be used to disregard the related person and treat the stock option as having been exercised and sold by the executive directly. Some of the considerations should include whether only the executive's funds were used to fund the related person or entity, whether the executive was the only individual who could benefit or lose from the transaction and whether there was any business justification to having the related entity act as an intermediary for the sale and exercise of the options.

In Long Term Capital Holdings, et. al. v. U. S., Dkt. No. 3:01cv1290 (JBA) Doc 2004-17390 (U. S. District Court for the District of Connecticut), the Court determined the end result test of the step transaction doctrine applied where there was evidence that the steps in the transaction were prearranged. In reaching its decision, the Court emphasized that where a finding of fact can be reached that the steps were prearranged to achieve a particular end result, the steps in the transaction may be collapsed.

ISSUE 5

Is the promissory note a valid debt?

COMPLIANCE'S POSITION

The Government argues that the promissory note from the FLP to the executive may fail to qualify as a valid debt.

TAXPAYER'S POSITION

The taxpayers argue that the transaction is valid and the debt is valid.

DISCUSSION AND ANALYSIS

Generally, for federal income tax purposes, a loan is defined as an enforceable obligation arising from a debtor-creditor relationship to pay a fixed or determinable sum of money. Goldstein v. Commissioner, T.C. Memo. 1980-273. No debt exists without a legal and enforceable obligation to repay. Courts look to various independent factors to determine if there is "a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship." Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973), acq. 1974-2 C.B. 3.

Whether a debtor-creditor relationship exists is determined by examining the subjective intent of the parties and all relevant objective facts and circumstances pertinent to the transaction. No one factor is determinative. See Hardman v. U.S., 827 F.2d 1409 (9th Cir. 1987); Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968); Gilbert v. Commissioner, 262 F.2d 512 (2d Cir.), cert. denied, 359 U.S. 1002 (1959). Factors examined by the courts include whether: (1) the promise to repay was evidenced by a note or other form of indebtedness; (2) interest was charged; (3) there is a fixed schedule for repayments; (4) security or other collateral was given to insure repayment; (5) there is a written loan agreement; (6) a demand for repayment was made; (7) the parties' records reflect the transaction as a loan; (8) repayments were made; and (9) the borrower was not insolvent at the time the advance was made. Goldstein v. Commissioner, supra. However, the circuit court to which the case could be appealed will be relevant because each circuit has established its own debt/equity factors. Thus, in determining whether the obligation is valid debt, the circuit to which the case could be appealed is a relevant factor.

Courts will subject a debt instrument to greater scrutiny where a close or family relationship exists between the debtor and creditor. Clark v. Commissioner, 18 T.C. 780, 783 (1952), aff'd., 205 F.2d 353 (2d Cir. 1953). Courts may excuse the absence of certain formalities when such close relationships exist. Litton Business Systems, Inc., supra at 377 (citing American Processing & Sales Co. v. United States, 178 Ct. Cl. 353, 371 F.2d 842 (Ct. Cl. 1967))(other citations omitted). However, the mere presence of significant objective indicia of indebtedness between related parties may not demonstrate a bona fide debt. In Fin Hay Realty Co., supra at 697, the court had to decide whether funds paid by shareholders of a closely held corporation were contributions to capital or loans. The court commented that "…all the formal indicia of an obligation were meticulously made to appear. The corporation, however, was the complete creature of the two shareholders who had the power to create whatever appearance would be of tax benefit to them despite the economic reality of the transaction."

Another factor to consider is whether the related person could have obtained the alleged debt on similar terms from an independent creditor. Litton Business Systems, Inc. v. Commissioner, supra at 379. Further, in Donisi v. Commissioner, T.C. Memo. 1967-62, aff'd, 405 F.2d 481 (6th Cir. 1968), one factor the court noted was that the transferor did not take readily available measures to ensure repayment, such as obtaining collateral for his loans.

In Georgiou v. Commissioner, T.C. Memo. 1995-546, the court noted that there were objective indicia of indebtedness but determined there was no bona fide debt because there was no indication that the shareholder intended to enforce the debt through his closely held corporation. Similarly, courts have found "where 'the same persons occupy both sides of the bargaining table,' the form of a transaction 'does not necessarily correspond to the intrinsic economic nature of the transaction'". Geftman v. Commissioner, 154 F.3d 61, 75 (3d Cir. 1998) (citing Fin Hay Realty, supra, at 697).

Most of the Notice 2003-47 transactions will have obligations, which meet all the formal requirements of a bona fide debt. However, failures to conform with the terms of a note, such as a failure to make any interest payments or the periodic acceleration of principal, or the complete repayment after a long period without repayments, will impact on whether the obligation will be respected by the court. See Geftman v. Commissioner, supra at 71 (citing Gilbert v. Commissioner, 74 T.C. 60 (1980)).

A finding that the obligation did not constitute valid debt will raise various issues depending on the specific facts and circumstances of the case, including issues of how the transfer of the stock options or restricted stock will be treated for purposes of Subchapter K and the gift tax provisions of the Code. This determination should be made based on the development of the facts and circumstances present in each case. Similarly, the presence or absence of the other factors discussed above would determine whether or not the obligation is valid debt.

ISSUE 6

Should the legal expenses or fees paid to create the transaction be deductible under §§ 162 or 212?

COMPLIANCE'S POSITION

The expenses associated with the 2003-47 transactions are not allowed as deductions under §§ 162 or 212.

TAXPAYER'S POSITION

The taxpayers did not present a separate argument for this issue. However, they argued that the transaction was valid and that all expenses are allowed.

DISCUSSION AND ANALYSIS

Case law has generally precluded the deduction of out-of-pocket costs of investing in a sham transaction. In Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 279 (1999), aff'd, 254 F.3d 1313 (11th Cir. 2001), cert. denied, 535 U.S. 986 (2002), the court applied the sham transaction doctrine to disregard the transactions and then turned to the issue of whether administrative fees paid to the scheme's promoter were deductible. Those fees constituted expenses of the taxpayer that contributed to the overall "out-of-pocket" economic loss suffered by the taxpayer as a result of its investment in the sham transaction. The court summarily disallowed these fees, stating that, "[t]hey were incurred in connection with, and were an integral part of, a sham transaction and, as a result, are not deductible." Thus, under this reasoning, if a transaction is determined to be a sham transaction, a taxpayer would not be entitled to any expenses incurred in connection therewith, even though those expenses reflected actual economic losses.

Similarly, in United States v. Wexler, 31 F.3d 117, 122 (3d Cir. 1994) cert. denied, 513 U.S. 1190 (1995), the Third Circuit stated, "Where a transaction has no substance other than to create deductions, the transaction is disregarded for tax purposes. Deductions for expenses resulting from such transactions are not permitted."

In several instances, individual tax shelter investors argued that they were entitled to deduct their "out-of-pocket" expenses on the basis that they suffered a theft loss pursuant to § 165. The courts concluded that cash "investments" in limited partnerships designed to secure tax benefits are not theft losses. See, e.g., Viehweg v. Commissioner, 90 T.C. 1248 (1988); Marine v. Commissioner, 92 T.C. 958 (1989), aff'd, 921 F.2d 280 (9th Cir. 1991) cert. denied, 502 U.S. 819 (1991).

The courts have not always disallowed other expenses, such as interest deductions on loans incurred in a transaction lacking economic substance. There have been instances in which a court allowed an interest deduction on a loan that was part of a transaction that lacked economic substance. In Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985), the court allowed the taxpayer to deduct interest, finding that, although the transaction lacked economic substance, the taxpayer was still obligated to make payments on the recourse note. The court in ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998), cert. denied, 526 U.S. 1017 (1999), also allowed the taxpayer to deduct interest. There, the court found that the taxpayer had actual economic losses associated with the notes and held that the notes were not the "centerpiece' but were "separable from the sham aspects of the underlying transaction."

Nonetheless, a number of cases have disallowed interest deductions where they were an integral part of a transaction found to lack economic substance. See Wexler v. United States, 31 F.3d 117, 125-26 (3d Cir. 1994), cert. denied, 513 U.S. 1190 (1995); Sheldon v. Commissioner, 94 T.C. 738 (1990); Saba Partnership v. Commissioner, T.C. Memo. 1999-359; Seykota v. Commissioner, T.C. Memo. 1991-541; Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967).

Because sham transactions lack economic substance, they do not give rise to valid deductions or losses - even for the taxpayer's out-of-pocket cash investment. The only circumstances where some courts have permitted deductions related to sham transactions are where the deductions were attributable to separable economically substantive elements that were not the principal tax benefit of the underlying sham transactions.

In the case of an individual or passthrough entity, there is a related alternative basis for disallowing shelter-related fees and similar costs. To deduct such costs under provisions such as §§ 162, 165, or 212, an individual must have a bona fide, primary profit motive independent of tax consequences. See Agro Science Co. v. Commissioner, 934 F .2d 573, 576 (5th Cir. 1991), cert. denied, 502 U.S. 907 (1991); Brown v. United States, 396 F .2d 459 (Ct. Cl. 1968); Price v. Commissioner, 88 T.C. 860, 886 (1987). These requirements also apply to partnerships at the entity level, determining the entity's motives by looking to those of its controlling individual or individuals. See Brannen v. Commissioner, 78 T.C. 471, 505 (1982), aff'd, 722 F .2d 695 (11th Cir. 1984).

ISSUE 7

Do the disclosure provisions of § 1.6011-4 apply to Notice 2003-47 transactions that were entered into prior to the release of Notice 2003-47, such that the disclosure is a factor that may affect the application of the Accuracy Related penalty?

COMPLIANCE'S POSITION

Compliance asserts that if the transaction is entered into on or after January 1, 2001, and the transaction was not reported on a return filed on or before June 14, 2002, the individual, trust, partnership, or S corporation is subject to the disclosure rules under § 1.6011-4 or § 1.6011-4T, as applicable. For all Notice 2003-47 transactions entered into by individuals, trusts, partnerships, or S corporations before January 1, 2001, there is no disclosure requirement under § 1.6011-4. For those transactions entered into on or after January 1, 2001, for which the transaction was reported on a return filed by June 14, 2002, there is no disclosure requirement under § 1.6011-4. Those regulations also provide rules applicable for transactions that are subsequently identified as listed transactions.

TAXPAYER'S POSITION

Taxpayer's generally argue that they are not subject to the disclosure requirements.

DISCUSSION AND ANALYSIS

In general, § 1.6011-4 requires a taxpayer who participates in a reportable transaction to file a disclosure statement. See § 1.6011-4(a). A reportable transaction includes a listed transaction, which is a transaction that is the same as or substantially similar to one of the types of transactions that the Service has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction. See § 1.6011-4(b)(1) and (2).

Notice 2003-47 identifies certain transactions, and any transaction that is substantially similar to the transactions described in the notice, as "listed transactions" for purposes of § 1.6011-4(b)(2). Under Notice 2003-47, transactions in which an individual purports to sell or otherwise dispose of an option described in § 83(e)(3) to a related person are listed transactions with respect to the individual and the related person if the purported sale or other disposition is in exchange for an amount that includes any deferred payment of money or property. The sale or disposition of substantially nonvested stock to a related person in exchange for an amount that includes any deferred payment of money or property is a substantially similar transaction.

The regulations under § 1.6011-4 were first issued on February 28, 2000, as temporary regulations. These regulations were then modified and finalized. A separate determination must be made as to whether each transaction is subject to the disclosure rules under § 1.6011-4 based on the date the taxpayer entered into the transaction and which version of the regulations or temporary regulations was in effect at that time. Generally, however, the disclosure rules applicable to individuals, trusts, partnerships, and S corporations under § 1.6011-4 will apply if the individual, trust, partnership, or S corporation entered into the transaction on or after January 1, 2001, and the transaction was not reported on a tax return of the individual, trust, partnership, or S corporation that was filed on or before June 14, 2002. See § 1.6011-4T(g) (TD 9000, 67 FR 41324).

Thus, for all Notice 2003-47 transactions entered into by individuals, trusts, partnerships, or S corporations before January 1, 2001, there is no disclosure requirement under § 1.6011-4. For those transactions entered into on or after January 1, 2001, for which the transaction was reported on a return filed by June 14, 2002, there is also no disclosure requirement under § 1.6011-4. However, if the transaction is entered into on or after January 1, 2001, and the transaction was not reported on a return filed on or before June 14, 2002, the individual, trust, partnership, or S corporation is subject to the disclosure rules under § 1.6011-4 or § 1.6011-4T, as applicable. Those regulations also provide rules applicable for transactions that are subsequently identified as listed transactions.

If the taxpayer had an obligation to disclose the Notice 2003-47 transaction under § 1.6011-4 and failed to do so, this failure to disclose is a factor that may be taken into account when evaluating the potential application of penalties under § 6662.

ISSUE 8

Is the adjustment attributable to the Notice 2003-47 transaction attributable to the negligence or disregard of rules or regulations or the substantial understatement of income tax provisions of § 6662?

COMPLIANCE'S POSITION

Compliance argues that under appropriate facts and circumstances, the Service should assert the negligence or disregard of rules or regulations and/or the substantial understatement of income tax provisions of § 6662 against a taxpayer for engaging in a transaction or substantially similar transaction described in Notice 2003-47. For purposes of applying the penalty provisions, Compliance does not consider the executive's position that the Notice 2003-47 transaction was at arm's length and resulted in deferral of the recognition of income to be based upon substantial authority.

TAXPAYER'S POSITION

Taxpayers generally argue that they relied on the advice of a tax professional to establish a reasonable cause defense.

DISCUSSION AND ANALYSIS

The transactions described herein are designated as listed transactions pursuant to Notice 2003-47, 2003-30 I.R.B. 1 (July 28, 2003) (identified as a listed transaction on July 1, 2003). The notice concludes that (1) the transfer of the stock options is not an arm's length transaction for purposes of § 1.83-7, and (2) the receipt of the deferred payment obligation from the related person results in immediate recognition of income. Accordingly, compensation income is recognized at the time of the transfer, with the potential for further compensation income at the time of exercise of the stock option by the related person.

In addition to Notice 2003-47, temporary regulations under § 83 issued concurrently with the notice provided that effective on or after July 2, 2003, the sale or other disposition of an option to a related person will not constitute an arm's length transaction for purposes of § 1.83-7. The regulations provide a definition of a related person that includes various family entities. Those regulations have subsequently been replaced with final regulations adopting the same rules. 68 FR 48392 (Aug. 10, 2004).

There are several statutory and judicial bases for challenging transactions described in Notice 2003-47. The applicability of some of the legal arguments depends upon the facts and circumstances of the particular case, and not all arguments are applicable to each case. Factual development is necessary to evaluate and assess each transaction.

Different fact patterns may exist. For example, variations could exist with respect to the transaction structure; the type of obligation transferred; the transaction reporting methodology; the timing and amount of the corresponding deduction claimed; the purported business purpose of the related person and the extent to which such business purpose was executed.

The transaction may or may not have been disclosed to the Service in accordance with Notice 2003-47. Disclosure should be a factor when considering application of penalties, as discussed above at Issue 7.

The Accuracy-Related Penalty

§ 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment[11] attributable to, among other things: (1) negligence or disregard of rules or regulations, or (2) any substantial understatement of income tax. § 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 (for example, negligence and substantial understatement of income tax). See DHL 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), where the Service alternatively determined that either the 40-percent accuracy-related penalty attributable to a gross valuation misstatement penalty under § 6662(h) or the 20-percent accuracy-related penalty attributable to negligence was applicable. The accuracy-related penalty provided by § 6662 does not apply to any portion of an underpayment on which a penalty is imposed for fraud under § 6663. See § 6662(b).

Negligence and/or Substantial Understatement

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. See §§ 6662(c) and 1.6662-3(b)(1). Negligence also includes the failure to do what

[11] For purposes of Section 6662, the term "underpayment" is generally the amount by which the taxpayer's correct tax is greater than the tax reported on the return. See Section 6664(a).

a reasonable and 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). § 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.

The phrase "disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. The term "rules and regulations" includes the provisions of the Code, regulations, revenue rulings or notices issued by the Service and published in the Internal Revenue Bulletin. See § 1.6662-3(b)(2). Therefore, if the facts indicate that a taxpayer took a return position contrary to any published notice or revenue ruling, the taxpayer may be subject to the accuracy-related penalty for an underpayment attributable to disregard of rules and regulations, if the return position was taken subsequent to the issuance of notice or revenue ruling. In this case, the transaction did not become listed until July 3, 2003, pursuant to Notice 2003-47, 2003-30 I.R.B. 1. Accordingly, a return filed after July 3, 2003 that fails to include income due to a Notice 2003-47 transaction will have taken a position contrary to a rule.

The accuracy-related penalty for disregard of rules and regulations will not be imposed on any portion of an underpayment due to a position contrary to rules and regulations if: (1) the position is disclosed on a properly completed Form 8275 or Form 8275-R (the latter is used for a position contrary to regulations)[12] and (2) in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation. This adequate disclosure exception applies only if the taxpayer has a reasonable basis for the position and keeps adequate records to substantiate items correctly. See § 1.6662-3(c)(1). Further, a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits. See § 1.6662-3(b)(2).[13]

A substantial understatement of income tax exists for a taxable year if the amount of the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. See § 6662(d)(1). Understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for such treatment or (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed on the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. See § 6662(d)(2)(B).

In the case of items of taxpayers, other than corporations,[14] attributable to tax shelters exception (2), above, (disclosure) does not apply and exception (1) applies only if the taxpayer also reasonably believed that the tax treatment of the item was more likely than not the proper treatment. See § 6662(d)(2)(C)(i). In this case, the transfer or sale of compensatory options or

[12] For transactions listed in Notice 2003-47 and entered into after December 31, 2002, taxpayers must also disclose the transaction as required by § 1.6011-4 (or §1.6011-4T), as applicable, to avoid a penalty for positions contrary to a rule or regulation on grounds of adequate disclosure.

[13] For transactions entered into after December 31, 2002, the listing of a transaction precludes a taxpayer from defending against a penalty for disregarding the notice on the ground that the taxpayer’s position has a realistic possibility of being sustained on its merits. See § 1.6662-3(b)(2).

[14] There is no ground to assert the accuracy-related penalty against the corporations participating in the transaction listed in Notice 2003-47 on the grounds of substantial understatement of income tax because corporations do not use the transaction to reduce their income tax.

restricted stock to related persons fits within the definition of a tax shelter[15] for the seller of the option. Thus, no reduction in the understatement will be available unless there was substantial authority for the tax treatment of the item and the executive reasonably believed that it was more likely than not the proper treatment.

The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. See § 1.6662-4(d)(2). There is substantial authority for the tax treatment of an item only if the weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. Weight is determined in light of the particular facts and circumstances of the case at hand and the weight accorded any particular authority depends upon its relevance and persuasiveness. See § 1.6662-4(d)(3). See also Long Term Capital Holdings, et. al. v. United States, 330 F.Supp.2d. 112 (D.Conn. 2004).

Although as discussed above, the executive may point to some authority for their position, the weight of that authority is not substantial in relation to the weight of authorities supporting contrary treatment. Executives have pointed to no authority directly supporting either the claim that this type of transaction should be treated as an arm's-length transaction or that the receipt of a deferred payment obligation under the circumstances of the transaction should result in the deferral of compensation income. Furthermore, in the context of the regulations, the executives' position is problematic on its face. The treatment of the "sale" of a compensatory option to a related person as an arm's length transaction for purposes of § 1.83-7 based solely upon the valuation of the option, rather than the facts and circumstances surrounding the transaction, including its terms, when the compensatory option was not taxed at grant under the same regulations because it did not have a readily ascertainable fair market value, renders meaningless the readily ascertainable fair market value standard. Rather, the executives' analysis reflects the strategic use of sentences in certain authorities which, when taken in context, should be seen as reflecting the conclusion that the transfer of a compensatory option in exchange for cash or other property results in compensation income, and not the broader propositions concluded by the executives. Similarly, the conclusion with respect to the deferral based upon the deferred payment obligation is problematic. Although the language of § 1.83-3(e) refers to an unfunded and unsecured promise to pay money or property in the future, it is evident when taken in the context that this reference refers to promises to pay in relation to the contract to perform services, and not the use of a third-party's promise as a substitute for the service recipient's obligation to pay the service provider. A contrary position would allow any employer to transfer an unsecured note from any third party in complete payment for the employee's services without any tax consequences to the employee. The Service's position in Revenue Ruling 69-50, 1969-1 C.B. 140, explicitly supports the proposition that a third-party obligation received as a payment for services results in the immediate recognition of income. Although executives may point to the Tax Court's decision in Childs, that decision never explicitly addressed the issue and only through inference can any contrary conclusion be reached. Accordingly, there is not substantial authority for the taxpayer's position with respect to the federal tax consequences of a Notice 2003-47 transaction.

---

[15] The definition of tax shelter includes, among other things, any plan or arrangement a significant purpose of which is the avoidance or evasion of federal income tax. See Section 6662(d)(2)(C)(iii).

Even if there were substantial authority, the executive must have reasonably believed that the tax treatment of the item was more likely than not the proper treatment. A taxpayer is considered to have reasonably believed that the tax treatment of an item is more likely than not the proper tax treatment if the taxpayer analyzes the pertinent facts and authorities and, based on his or her independent analysis, reasonably concludes in good faith, that there is a greater than 50 percent chance that the tax treatment of the item will be upheld if challenged by the Service. The taxpayer may also reasonably rely, in good faith, on the opinion of a professional tax advisor. The opinion must clearly state that, based on then advisor's analysis of the facts and authorities, the advisor concludes that there is a greater than 50 percent change that the tax treatment will be upheld if the Service challenged the position. See § 1.6662-4(g)(4)(i)(A), (B). Moreover, if the taxpayer is relying on tax advice to establish reasonable belief, the taxpayer must also meet the requirements generally applicable to relying on advice to establish good faith and reasonable cause. See § 1.6662-4(ii). As discussed more fully below, this standard will rarely be met where the advice relied upon consists of the opinion of the promoter of the transaction.

The Reasonable Cause Exception

The accuracy-related penalty does not apply to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that the taxpayer acted in good faith. See § 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case by case basis, taking into account all pertinent facts and circumstances. See § 1.6664-4(b)(1). All relevant facts, including the nature of the investment, the complexity of the tax issues, issues of independence of a tax advisor, and the sophistication of the taxpayer must be developed to determine whether there was reasonable cause and good faith. Generally, the most important factor is the extent of the taxpayer's effort to assess his proper tax liability. Id. See also Larson v. Commissioner, T.C. Memo. 2002-95.

Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Reliance on professional advice, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Id. In determining whether a taxpayer has reasonably relied on professional tax advice as to the tax treatment of an item, all facts and circumstances must be taken into account. See § 1.6664-4(b)(1).

The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purpose (and the relative weight of such purposes), for entering into a transaction and for structuring a transaction in a particular manner. A taxpayer will not be considered to have reasonably relied in good faith on professional tax advice if the taxpayer fails to disclose a fact it knows, or should know, to be relevant to the proper tax treatment of an item. See § 1.6664-4(c)(1)(i).

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

In Long Term Capital Holdings, Inc. the Court did not find the taxpayer's reliance on the opinion of a promoter was reasonable where (1) the taxpayer did not receive the written opinion prior to filing its tax return, and there was no evidence in the record to establish the nature of the opinion prior to receipt of the written opinion; (2) the opinion was based upon unreasonable assumptions that the taxpayer had a legitimate business purpose and that there was no prearranged plan to sell the stock at issue; (3) there was insufficient legal analysis of the judicial doctrines of step and business purpose; (4) there was no internal review of the opinion, and (5) the taxpayer took steps to conceal the transaction through netting on its returns.

Further, where a tax benefit depends on non-tax factors, the taxpayer also has a duty to investigate such underlying factors. The taxpayer cannot simply rely on statements by another person, such as a promoter. See Novinger v. Commissioner, T.C. Memo. 1991-289 (taxpayer could not avoid the negligence penalty merely because his professional advisor had read the prospectus and had advised the taxpayer that the underlying investment was feasible from a tax perspective, assuming the facts presented were true). Moreover, if the tax advisor is not versed in these non-tax factors, mere reliance on the tax advisor does not suffice. See Addington v. United States, 205 F.3d 54 (2d Cir. 2000) (taxpayer's reliance on tax advisor was not reasonable given the cautionary language in offering memoranda and the tax advisor's lack of adequate knowledge to evaluate essential aspects of underlying investment); Freytag v. Commissioner, 89 T.C. 849 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990) (reliance on tax advice not reasonable where taxpayer did not consult experts with respect to the bona fides of the financial aspects of the investment); Goldman v. Commissioner, 39 F.3d 402 (2d Cir. 1994) (taxpayer's reliance on accountant's advice to invest in a partnership engaged in oil and gas was not reasonable where accountant lacked industry knowledge); Collins v. Commissioner, 857 F.2d 1383 (9th Cir. 1988) (penalties upheld where advisor "knew nothing firsthand" about the venture).

Reliance on tax advice may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of the federal tax law. See § 1.6664-4(c)(1). For a taxpayer's reliance on advice to be sufficiently reasonable so as possibly to negate a § 6662(a) accuracy-related penalty, the Tax Court in Neonatalogy Associates P.A. v. Commissioner, 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: (1) the advisor was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer gave to the advisor the necessary and accurate information, and (3) the taxpayer actually relied in good faith on the advisor's judgment.

SETTLEMENT GUIDELINES

ISSUES 1 AND 2

For purposes of our settlement guidelines discussion we will start with the legal issues, then conclude with a discussion on the factual variations and potential impact, if any, upon settlements.

Since Issue 2 is primarily a legal issue that should be dispensed with before addressing the “arm’s length” query under § 83, the Appeals Settlement Guidelines will start by addressing Issue 2.

Issue 2

> Whether the transfer of the unfunded/unsecured promissory note (or similar deferred obligation, annuity or contract) from the related party to the executive [service provider] results in the immediate recognition of income under § 83?

We believe that the government has made a meritorious case rebuking the taxpayer’s assertions of entitlement to deferral until such time as the related party pays the underlying debt (i.e. 15 to 30 years). Any potential risk of an extremely literal reading of §§ 1.83-7, 1.83-1(c) and 1.83(e) is seen as representing minor to de minimis litigation hazards for the government. However, all pertinent facts and circumstances in each case should be considered in evaluation of such hazards.

§ 83 applies to “Property transferred in connection with the performance of services.” Under the general rules of § 83, the FMV of the option is included in income at the time of receipt unless the option is both nontransferable and subject to a substantial risk of forfeiture.
Options are taxed in the year of receipt provided there are no restrictions on transferability or a substantial risk of forfeiture. However, the transfer of an option without a readily ascertainable fair market value is an exception to the general rule. Hence, there is a potential under § 83 for deferral of compensation income beyond the date of receiving options (until disposition or exercise). There is no provision for the deferral of income claimed by the taxpayers in this transaction (deferring compensation income for 15 to 30 years until such time as the related party satisfies the debt).

Taxpayers have advocated a rather strained reading of § 83. An employer’s promise of payment that is unfunded and unsecured would not result in taxable income to the employee unless such amount is funded and vested, or paid. While it is agreed that the receipt of an unfunded, unsecured obligation from the service recipient (employer) would not be taxable income to the executive until such time as the funds were made available or the promise is funded and secured, such is not the case with respect to the transaction between the FLP (a third party) and the executive. Accordingly, to be successful, the executive must move the related party into the position of the service recipient (employer) to assert that the executive’s receipt of the unfunded, unsecured obligation from the FLP or other third party removes the transfer from the application of § 83 for purposes of determining the timing of compensation income to the executive. But the executive never performed services for the FLP, nor did the executive receive the FLP’s obligation as part of any agreement to perform services, but instead as consideration for the transfer of the option.

In Notice 2003-47 transactions, taxpayers argue that there is no current recognition of income because of the deferred obligation and because the transfer was a transaction conducted at arm's length. The alleged arm's length disposition is to the FLP (related party) for an unsecured unfunded obligation. Even assuming arguendo that the transaction was at arm's length, the executive would still be required to report compensatory income, upon disposition of the options to the third party, measured as the difference between the amount realized (the obligation) and the basis in the options (typically zero).

§ 83 applies to the transfer of property in connection with the performance of services. The sale of the options to the FLP [related party] for an unsecured, unfunded obligation does not place the FLP in the shoes of the employer, service recipient, for purposes of § 83. The deferred obligation is and remains a third party obligation. The provisions under § 1.83-7 were not intended to alter the treatment of the transfer of options or restricted stock as a sale or exchange of property.

Executives will likely argue that the decision of the Tax Court in Childs v. Commissioner, 103 T.C. 634 (1994), aff'd without op. 89 F .3d 856 (11th Cir. 1996) provides that third party obligations are not treated as property under § 83. This decision is not on point. The facts present in 2003-47 transactions are not the same facts present in the Childs case. The Childs case did not involve a sale of options. The case is distinguishable and hence, lacks precedent value for the taxpayer.

Childs involved a structured settlement with respect to services provided by an attorney. The plaintiffs' attorneys had agreed to a contingent fee arrangement. When the parties entered into a settlement agreement, the defendant agreed to pay the attorneys their portion of the fees directly, and to purchase an annuity to provide the payment. The court stated that the attorneys were not in constructive receipt because the agreement was reached before the payment was offered. The court then went directly into the analysis of whether the annuity funded the defendant's obligation to pay the attorneys, and so was property under § 83. Executives argue that this should be read to provide that third party obligations are not property for § 83 purposes. However, the court failed to address whether the attorneys had already received property because the plaintiff (service recipient) had paid for the attorneys' services by giving the attorneys the defendants' promise to pay.

Furthermore, the case involves a structured settlement in which the service provider's compensation was contingent upon and stemmed directly from the payment by the third party. In essence, the service recipient (the plaintiff) established a portion of its own funds (the potential settlement) as the only source from which the service provider would be paid. Although technically the service provider received a promise from the third party (the defendant), the service provider in substance continued to possess an unsecured interest in a portion of the service recipient's funds (the potential settlement which otherwise would have been paid to the service recipient), which would not be available until the settlement was paid. So, for example, the decision may mean that an employee who was promised a commission on a sale if and when the customer paid, which instead of being paid to the employer and then forwarded to the employee would be paid directly by the customer to the employee when the product was purchased, would not be deemed to have received property if the employee received only the customer's unsecured promise to pay. In contrast, the decision does not address situation such as a Notice 2003-47 transaction where a third party obligation is treated as a payment by the service recipient for services unrelated to the issuance of the obligation, without any prearrangement between all the parties. Accordingly, the decision does not address whether under those circumstances the obligation would be viewed as § 83 property. The decision never explicitly addressed the issue of dispositions of compensatory options. The Childs decision is not dispositive of a distribution of an option to a third party for an unsecured unfunded promissory note. Childs does not address a situation even remotely similar to a Notice 2003-47 transaction.

Once we've determined that the taxpayer's structuring of the transaction in this manner will not result in the purported long term deferral of compensatory income (i.e. 15 to 30 years), we turn to the question of when and in what amount(s) should income be reported. A crucial piece to this puzzle will be determining whether the transaction is arm's length.

Issue 1

Whether the transaction is an arm's length transaction for purposes of § 83?

This is both a legal and a factual issue.

Given the facts presented in the Coordinated Issue Paper and evaluation of cases experienced to date, we believe that the government's hazards of litigation are de minimis and as such, recommend full sustention of the government's non-arm's length position. Compensation income is to be recognized at disposition in the amount of money and property received by the executive including the FMV of the obligation of the third party. There is also the potential for additional compensation income to be recognized by the executive when the FLP exercises the options.

This conclusion generally applies to transactions in which facts presented and developed by the Government indicate a failure by the taxpayer to conduct the transaction in an arm's length manner. Factors to support such a conclusion include that the FLP is created to facilitate the transaction and the intended deferral, the FLP is created from contribution of which the majority was contributed by the executive, and the FLP is involved in relatively minor business activities with the executive serving as a general partner and having defacto control over the FLP's activities and operations.

Some transactions may involve significant factual variations that may impact the determination of litigation hazards with respect to the arm's length issue. Appeals Officers must consult with the Appeals Technical Guidance Coordinator for an evaluation of litigation hazards with respect to such transactions.

Under the general rules of § 83, options are taxed in the year of receipt provided there are no restrictions on transferability or substantial risks of forfeiture. In contrast, options without a readily ascertainable fair market value are an exception to the general rule, so there is the potential under § 83 for deferral of compensation income beyond the date of receiving options (until disposition or exercise).

All parties agree these options did not have a readily ascertainable fair market value at the time they were provided by the service recipient [employer] and consequently are not taxed under § 83 when granted to the executive. While § 1.83-3(a)(2) provides that § 83(a) does not apply to the grant of an option without a readily ascertainable fair market value, see § 1.83-7 for the rules governing the taxation of the options, including the impact and application of § 83 to transactions involving these options.

So if the grant of these options is not subject to § 83(a) and it is agreed that they are not taxed at grant, how does § 1.83-7 apply?

§ 1.83-7(a) provides that if § 83(a) does not apply to the grant of the option because the option does not have a readily ascertainable FMV at grant, § 83(a) and § 83(b) shall apply at the time the option is exercised OR otherwise disposed of.

When the options are disposed of, one must consider whether the transaction is an arm's length transaction.. This is important in determining when the transaction actually closes for purposes of § 83. If it is an arm's length transaction, the application of § 83 ends and the executive reports as compensation income the amount of property received. In contrast, if the transaction is not an arm's length transaction, the executive generally reports compensation income in the amount of the value of the property received at the time of the initial disposition and the transaction remains open until such time as the options finally expire or are exercised. Consequently, the executive may have to report additional compensation income when the options are finally exercised by the FLP, related party (transferee).

Example:

An executive is granted an option to purchase 100 shares at $ 1 each. He sells this option for $ 200 in 2000 when the FMV of the underlying stock is $ 3 per share. If the sale is at arm's length, the executive recognizes compensation income in the amount of $ 200 in 2000. The exercise of the option by the purchaser at a later date (say, for example when the FMV of the underlying stock has increased to $ 4 per share in 2001) will not affect the executive's compensation income.

In contrast, if the sale in 2000 is not an arm's length transaction, the taxpayer will recognize the $ 200 compensation income in 2000, but the transaction remains open for purposes of § 83. If, in 2001, at the time of exercise, the FMV of the underlying stock has increased by $ 1 per share, the executive will be required to recognize the additional compensation income of $100. (Purchaser paid $ 200 in 2000 and received the option. In 2001, he paid an additional $ 100 to exercise the option and received 100 shares valued at $ 400. The executive recognized $ 200 in 2000 when the option was sold. When the option is exercised, he will report an additional $ 100 in 2001 based upon the exercise).

So a determination as to whether the disposition was at arm's length or not has an impact on what is to be recognized and when by the executive. This is why an evaluation of the factors supporting the government position or that of the taxpayer is important.

If the disposition is conducted at arm's length, then the executive is to recognize compensation income at the time of disposition and in the amount received as an obligation from the FLP. If the disposition is not an arm's length transaction, then the executive will recognize income at disposition in the amount received and may have additional compensation when the FLP exercises the options. If the FMV of the underlying stock has appreciated, that can be a significant amount to be recognized in the year of exercise by the FLP.

Taxpayers argue that since the FMV was used to establish the sales price, the transaction must be considered to be at arm's length. Often in these transactions the options valuation does not consider the option privilege whereas a sale at arm's length would typically have taken such value into account. Even if such valuation was properly calculated it's important to note that FMV is only one consideration and not dispositive of the arm's length issue.

The taxpayers' arguments center on lack of guidance as to what an arm's length transaction is. They attempt to borrow from other legislative provisions that fall short, §§ 482 and 7872, in providing guidance on the definition of an arm's length transaction. § 482 grants authority to the Secretary to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among controlled organizations, trades or businesses to prevent evasion of taxes or clearly reflect income. § 7872 does not address FMV but rather recharacterizes certain below-market loans in a way that the legislative history of 7872 describes as "arm's length". As set forth in the Coordinated Issue Paper and earlier discussion of issues 1 and 2, the taxpayers' attempt to rely on §§ 482 and 7872 is not persuasive. We believe that a court would also find these arguments to lack merit. Further, should the taxpayer assert that cases in the Estate and Gift arena are germane to the distribution of § 83 issues, it would be appropriate for the Service to distinguish the § 2036 cases. Compare, for example, Kimbell v. US, 2004 U.S. App. LEXIS 9911 (5th Cir., May 20, 2004), where the court in applying § 2036 noted that there is a long-held position that related parties may enter into bona fide arms length transactions for adequate consideration, and Turner v. Comm., 2004 U.S. App. LEXIS 18473 (3rd Cir., Sept. 1, 2004), where in applying § 2036 the court distinguished a bona fide sale from an arm's length transaction suggesting that inter-family transfers will not be at arm's length unless the family members' interest are sufficiently divergent.

As stated earlier, the use of FMV does not make a transaction an arm's length transaction under § 83, though arguably it is a factor for consideration. One must consider all the facts and circumstances in rendering a determination. Executives/taxpayers will argue that the facts and circumstances test is not the appropriate standard, stating that it only requires payment of fair market value. The Service counters that in order to accommodate the regulatory structure, the term must mean more than simple payment of fair market value, otherwise the fair market value term would have been used or the option would have been found to have a readily ascertainable fair market value. It is highly likely that the courts will look to the totality of the transaction, evaluating whether the executive would have conducted the transaction in a similar manner with an independent party.

A typical Notice 2003-47 transaction will include the following factors:

? Options were not valued to include the value of the option privilege under Black-Scholes or similar methodology (FMV determination discussed previously)
? The option was sold and the FLP exercised the option within few months if not weeks
? The executive was a majority contributor to the FLP
? The FLP was created a few weeks before the disposition of the option occurred
? Pre-arranged contrived steps to arrive at tax benefits
? Taxpayer's retention of control [direct or indirect through control of the FLP and its operations] over the option and the obligation
? Relationship between the parties to the transaction and defacto control by the executive of the transaction and the activities of the FLP
? Terms of the agreement provide minimal protection for the taxpayer
? Terms of the obligation do not reflect arms length negotiations

In a true arm's length transaction, it is highly unlikely that an executive would have sold his/her options to an unrelated third party for an unsecured and unfunded promissory note payable in

15 to 30 years. When one considers the relationship between the related party [and partners/owners] and the taxpayer it is evident that the structure of the transaction was set up to effect tax avoidance for 15 to 30 years or similar terms. By virtue of family relations, taxpayers generally continued to exercise the same control over the options as he/she would have had if he/she had not disposed of the options to the related party. It is highly likely that a court will look at the substance of the transaction, including the relationship of the parties and their behaviors, looking beyond the form to determine whether a truly arm's length transaction is present. It is the totality of the evidence that will be considered, family relationship being just one factor.

The executives typically sold the options to a FLP or other related entity owned or controlled (directly or indirectly) by the executive and his/her family members. In most cases, the FLP was created just a few weeks, if not days, before the sale of the options. The executive was the owner of the options prior to the creation of the FLP and retained control and indirect ownership through his direct and indirect ownership interest in the FLP (often via close family relations). It's not unusual for the options to be virtually the only assets owned by FLP that had no or limited other investment/business activity. This unfunded and unsecured obligation has the potential of being abandoned over time. One should determine whether the entity was created for the purpose of facilitating this transaction.

While it is not unusual for the FLP to have been created for the purpose of this transaction, it is possible that an existing FLP may have been utilized. When that is the case, particular focus should be on the actual transaction. Courts recognize that a tax shelter activity may occur within an otherwise viable entity and are willing to look to the substance of the transaction in deciding the fate of the taxation, see <u>Long Term Capital Holdings v. United States</u>, F. Supp. 2d, 2004 U.S. Dist. LEXIS 17159 (D. Conn. August 27, 2004).

Often the FLP exercised these options within few a weeks, if not days of the disposition by the executive. It was not unusual for the FLP to sell the stock shortly thereafter, though some related entities may have held the stock as an investment. It should be noted that for purposes of the § 83 discussion, failure of the FLP to sell the stock does not weigh against the Service's position. The entirety of the transaction and all facts and circumstances need to be explored.

Based upon the facts and circumstances outlined herein, Compliance's position provides reasonable analysis as to why such a transaction should not be considered an arm's length transaction. Hazards under this set of factual variations are de minimis. As stated earlier, there may be factual variations that may have an impact upon the settlement. Appeals Officers are instructed to contact the coordinator should such variations emerge. Facts that may potentially impact whether the transaction is considered arm's length include such items as, limitations on distributions from the FLP until the obligation is satisfied, true relinquishment of control over the FLP, explicit plausible partnership restrictions, significant pre-existing investment activity at the FLP level where there is limited control by the executive, etc., significant capital contributions by other partners, etc.

It is important to note that the factual variations contained in the CIP and those evaluated to date by Appeals reflect very short time frames between the disposition of the options to the related entity and the entities exercise of the options. As such, in most cases, the determination of whether the transaction is at arm's length for purposes of § 83 will have minimal impact assuming the deferral argument made by the taxpayer is not valid. Under those circumstances, an arm's length determination only changes the application of § 83 from the time of disposition and potentially again at the time of exercise (non-arm's length) to the time of disposition (arm's length).

So with respect to the arm's length argument, assessment of litigation hazards vary based on factual development and variations involved. Such argument reflects a range of litigation hazards, depending on the specific facts and circumstances of the case.

Some factual variations do impact the assessment of litigation hazards. In a case involving the factors described in Notice 2003-47 and present in cases reviewed, the litigation hazards are de minimis. This is where the FLP was created to facilitate the transaction and the executive retained control over the FLP through equity and direct operation. In cases where the FLP was well established prior to the transaction, the executive's equity and control are reduced through other members contributions, and the FLP obligation is secured through limitations on distributions and diversification of investments to lower the risk for the executive. These factors do present some hazards. This may impact the amount to be recognized and the timing of such recognition. Appeals Officers are instructed to contact the coordinator should such variations emerge.

The Government's position is that a court will review the facts and circumstances surrounding the transaction and that the transaction must reflect that the executive has entered into the transaction under terms to which he would have agreed to with a truly independent third party. Facts indicating a sale for consideration in the form of an unsecured balloon payment obligation, financing of the consideration predominantly by the executive and his control over the FLP would show a non-arm's length transaction and taxation should be at disposition and at exercise.

Based upon the analysis of the issues presented by Compliance, the promoters and the taxpayers involved in such transaction, it is Appeals' opinion that issue two should be sustained in full. There should be no deferral allowed. With respect to issue one, the Government's chance of prevailing is extremely high based on the facts and circumstances presented in the majority of cases identified and described above. In such cases, the Government's hazards are minimal. However, in some circumstances, there can be some significant factual variations which increase the litigation hazards for the Government with respect to the issue of arm's length as stated above. In such cases, Appeals Officers are instructed to discuss with the Technical Guidance Coordinator.

The remaining issues raised by the Government are the application of the Judicial Doctrines, the Anti-Abuse regulations under § 1.701-2, the validity of the obligation and the penalty application. Each of these arguments is subject to its own separate litigation hazards assessment and the outcome depends on a variety of factors.

ISSUE 3

The regulation under § 1.701-2 operates to implement the Congressional intent underlying Subchapter K providing that the Commissioner can recast a transaction "if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K."

Appeals agrees that these transactions are subject to recharacterization under Treas. Reg. § 1.701-2, based on the following factors:

First, the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership asset and conducted the partnership's activities directly. See § 1.701-2(c)(1). Assuming that the executive's arguments with respect to the amount and timing of compensation income recognition in a Notice 2003-47 transaction were valid, the present value of the partners' aggregate federal tax liability would be much greater if the executive who held the compensatory stock option retained individual ownership of the stock option and then carried out the activity of the partnership by exercising the option directly, because the executive would have had to recognize the compensation income immediately upon exercise of the option. This is true whether the partnership was formed for the purpose of engaging in this transaction or an existing partnership was used to engage in the transaction.

Another factor on the list is that one or more partners who are necessary to achieve the claimed tax results have a nominal interest in the partnership. See § 1.701-2(c)(3). In many of the Notice 2003-47 transactions, the partners, other than the individual holding the compensatory stock option, have very minor interests in the partnership.

A third factor indicative of intent is that substantially all of the partners are related (directly or indirectly) to one another. See § 1.701-2(c)(4).

A fourth factor is that the benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the individual (or a related party). See § 1.701-2(c)(6). In these transactions, the executive's family members are usually the other partners in the partnership, thereby maintaining control of the property within the executive's family.

A fifth factor is that the form of each partnership transaction must be respected under substance over form principles. See § 1.701-2(a)(2). The substance of the Notice 2003-47 transaction is that the executive exercises the compensatory stock options or transfers the restricted stock and effectively retains control (directly and through family members) of the proceeds. The form of the transaction makes it appear that the exercise of the options is carried out by a separate party and that individuals other than the executive have control of the proceeds. The form does not reflect the substance of the transaction.

Finally, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transactions were respected for federal tax purposes. The Service believes that a partnership formed or availed of in connection with a Notice 2003-47 transaction does not operate in a manner consistent with the intent of subchapter K. In the Notice 2003-47 transactions, the requirement that each partnership be bona fide and that each partnership transaction or series of related transactions be entered into with a substantial business purpose is not met. A partnership formed or availed of in connection with this transaction often engages in a minimal amount of investment transactions to generate the appearance of a business purpose in the event the transaction is challenged. Other than these minimal investments activities, the partnership may engage in no other business activity. The real purpose of the partnership is the delay or avoidance of the recognition of compensation income and gain through the Notice 2003-47 transaction. Although establishment of substantial business purpose is a fact-specific inquiry, the reasonable expected pre-tax profit from the investment transactions is minimal when compared to the purported avoidance of tax liability achieved through this transaction.

It is very likely that a court would hold that a principal purpose for the transaction at issue was to substantially reduce the present value of the partners' aggregate federal tax liability. It is also highly likely that a court would hold that there is no substantial business purpose for the transaction because any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transactions were respected for federal tax purposes. Therefore, the Commissioner should be able to recast the transaction.

In summary, in order to recast a transaction under the partnership anti-abuse rule, (1) a principal purpose of the transaction must have been to substantially reduce the present value of the partners' aggregate federal tax liability and (2) this reduction must be inconsistent with the intent of Subchapter K. Therefore, because it is likely that the Government would be able to establish both of these factors, it is expected that a court would uphold the Commissioner's right to apply the anti-abuse rule to recast the transaction. If the Service were to prevail on this issue, the transaction would be restructured as if the executive exercised the option, then contributed the proceeds to the FLP or other related entity. This is similar to the results under several of the common law doctrines.

ISSUE 4

Economic Substance

Litigation hazards in the area of the application of Judicial Doctrines are difficult to assess because the outcomes are dependent on a variety of factors.

The following factors have been found in the majority of Notice 2003-47 transactions considered to date (CIP fact pattern and Appeals evaluation of cases). These factors tend to support a finding that the transactions lack economic substance: (1) Often the entity was created only to facilitate a purported sale of the options, and thus the creation of the entity has no business purpose. (2) The taxpayer was the owner of the options prior to the creation of the entity and retained ownership and control through his interest in the entity and that of close family relations. (3) These relatives often have nothing more than a nominal interest and may not be contributing capital or any service to the related entity. (4) Often the options are virtually the only assets of the entity that has no other business activity. (5) The obligation is unfunded and unsecured and may likely be abandoned over time. (6) The economic effect of the transaction is to enable the taxpayer to pick up the relatively minimal amount of interest income received from the obligation (which may be largely offset by the corresponding interest deduction of the entity in which the taxpayer holds a significant interest), defer the large amount of income he would have reported upon exercise of the options and sale of the acquired stock or vesting of the restricted stock, and obtain the flow through deduction of the related entity's interest payment.

A finding that there is no economic substance to the transactions would eliminate the purported delay or avoidance of compensation income and gain recognition generated by the Notice 2003-47 transaction.

However, as explained under Issue 1, there may be some significant variations from those described in a typical 2003-47 transaction. Such variations do impact the assessment of litigation hazards with respect to the application of the Judicial Doctrines and the arm's length argument. These variations may include such factors as the creation of the FLP and the scope of its business activities, security for the obligation, limitation on distributions from the FLP, recourse against individual partners, sources of contributions to the FLP and the degree of the executive's ownership and control. These factors should be considered and if such factors are present, Appeals Officers are instructed to contact the coordinator for assessment of litigation hazards.

Substance over Form and the Sham Doctrine

A transaction which exalts form over substance solely to obtain tax benefits will not be recognized. Although the form of a transaction may comply with the Internal Revenue Code, it will not be given effect where it has no business purpose and operates as a device to conceal the true character of a transaction. Andantech v. Commissioner, T.C. Memo. 2002-97, aff'd in part and remanded in part, 331 F.3d 972 (D.C. Cir. 2003). "A transaction is a sham if it is fictitious or if it has no business purpose or economic effect other than the creation of tax deductions". DeMartino v. Commissioner, 862 F.2d 400 (2d Cir. 1988). Courts will not construe a statute to permit sham transactions. Knetsch v. United States, 364 U.S. 361 (1960); United States v. Wexler, 31 F.3d 117 (3^{rd} Cir. 1994), cert. denied, 513 U.S. 1190 (1995) (a sham transaction will not be recognized and, therefore, cannot be the basis for a deduction). A transaction that fails to create a genuine obligation would "…exalt artifice above reality and … deprive the statutory provision in question of all serious purpose." Gregory v. Helvering, 293 U.S. 465, 470 (1935).

The sale of the compensatory stock options to a closely-held, related entity in exchange for an unfunded, unsecured deferred payment obligation is highly relevant to a determination as to whether the transfer of the options and the obligation were shams.

The Step Transaction Doctrine

In determining whether to apply the step transaction doctrine, look to whether the interdependence test and/or end result test could be used to disregard the related person and treat the stock options as having been exercised and sold by the taxpayer directly. This argument will depend on the particular facts of the case. To direct a challenge under the step transaction doctrine some considerations should include (but not be limited to) the following: whether only the taxpayer's assets were used to fund the related person or whether there were other investors, whether the taxpayer was the only individual who could benefit or lose from the transactions, whether there was any business justification to having the related person act as an intermediary for the exercise and sale of the options.

The steps designed by the promoters and followed by the executives involved in this transaction are intended to show that the transaction was an arm's length transaction and that the executive can defer the recognition of compensation income as long as he or she finds accommodating. Such an interpretation of § 83 should not prevail. It is Appeals opinion that a court will find such interpretation to be tax avoidance and a violation of the intent of the law.

The Common Law arguments raised by Compliance provide additional support for the Government's conclusion that the transaction is nothing more than a sham transaction with one purpose, which is the long-term deferral or avoidance of compensation income by the executives.

All of these arguments apply and the strength and weakness of such arguments depends on how they are presented and the facts and circumstances present in each case. However, in a typical 2003-47 transaction as described in this document, the chance of the Government prevailing is very high given the fact that the main issue is § 83 and that in such cases, the FLP was created to facilitate the deferral. Several factors are considered:

? The taxpayers' motive in entering into the transaction
? The facts and circumstances surrounding the transaction
? Whether there is a bona fide transaction with economic substance imbued with tax independent considerations.

The executives sold their options to a related entity, which exercised such options within a very short period of time. The executives reported the sale on the Installment Plan and the related entities sold the stock and received the cash. The second disposition is taxable to the first seller. § 453(e).

The facts and circumstances surrounding the transaction all point to one goal, the establishment of a series of steps to accomplish the deferral.

If the taxpayers are to prevail, they must prevail in all of these arguments. In addition, they must prevail on both arguments, that the transaction was at arm's length and that the obligation was not property under § 83, and did not otherwise result in the recognition of income at the time of transfer in order for them to be allowed a deferral.

If the Government prevails in any of these arguments and the transaction is found to be a sham it will be ignored for federal tax purpose. Note, that if the Service prevails on the substance v. form (sham), economic substance or similar common law doctrines, the transfer or other disposition of the stock options from the taxpayer to the related party would be ignored and fully taxed to the taxpayer upon his/her [related person] exercise of the stock options. The facts necessary to demonstrate lack of economic substance, sham or similar common law doctrines would be similar to the facts necessary to demonstrate that the debt was invalid (issue 5) and that deduction of the expenses was not available (Issue 6).

The executive prevailing in all of these arguments is very unlikely. The executive faces substantial litigation hazards with respect to the deferral issue and substantial hazards with respect to the arm's length argument and the application of the Judicial Doctrines based on a typical transaction implemented for deferral purposes. The taxpayers also face litigation hazards with respect to the application of the Anti-abuse regulations. The litigation hazards under such arguments are based on factual development presented by the Government.

ISSUE 5

Courts will subject a debt instrument to greater scrutiny where a close or family relationship exists between the debtor and creditor. Clark v. Commissioner, 18 T.C. 780, 783 (1952), aff'd., 205 F.2d 353 (2d Cir. 1953). Courts may excuse the absence of certain formalities when such close relationships exist. Litton Business Systems, Inc., supra at 377 (citing American Processing & Sales Co. v. United States, 178 Ct. Cl. 353, 371 F.2d 842 (Ct. Cl. 1967))(other citations omitted). However, the mere presence of significant objective indicia of indebtedness between related parties may not demonstrate a bona fide debt. In Fin Hay Realty Co., supra at 697, the court had to decide whether funds paid by shareholders of a closely held corporation were contributions to capital or loans. The court commented that "…all the formal indicia of an obligation were meticulously made to appear. The corporation, however, was the complete creature of the two shareholders who had the power to create whatever appearance would be of tax benefit to them despite the economic reality of the transaction."

Another factor to consider is whether the related person could have obtained the alleged debt on similar terms from an independent creditor. Litton Business Systems, Inc. v. Commissioner, supra at 379. Further, in Donisi v. Commissioner, T.C. Memo. 1967-62, aff'd, 405 F.2d 481 (6th Cir. 1968), one factor the court noted was that the transferor did not take readily available measures to ensure repayment, such as obtaining collateral for his loans.

In Georgiou v. Commissioner, T.C. Memo. 1995-546, the court noted that there were objective indicia of indebtedness but determined there was no bona fide debt because there was no indication that the shareholder intended to enforce the debt through his closely held corporation. Similarly, courts have found "where 'the same persons occupy both sides of the bargaining table,' the form of a transaction 'does not necessarily correspond to the intrinsic economic nature of the transaction'". Geftman v. Commissioner, 154 F.3d 61, 75 (3d Cir. 1998) (citing Fin Hay Realty, supra, at 697).

Most of the Notice 2003-47 transactions will have obligations which meet all the formal requirements of a bona fide debt. Factors to consider include the amount of interest charged, whether there were repayments, the solvency of, capitalization and creditworthiness of the FLP, the partners in the FLP (relating to the nature of the relationship between the parties), whether the terms of the note were similar to the terms the FLP could have obtained from an independent creditor, and whether the parties' behavior was consistent with the terms of the note (for example, whether the required payments were made or allowed to be deferred). However, failures to conform with the terms of a note, such as a failure to make any interest payments or the periodic acceleration of principal, or the complete repayment after a long period without repayments, will impact on whether the obligation will be respected by the court. See Geftman v. Commissioner, supra at 71 (citing Gilbert v. Commissioner, 74 T.C. 60 (1980)).

A finding that the obligation did not constitute valid debt will raise various issues depending on the specific facts and circumstances of the case, including issues of how the transfer of the stock options or restricted stock will be treated for purposes of subchapter K and the gift tax provisions of the Code. The facts and circumstances in each transaction should be considered. Factual development will impact upon the determination as to whether the debt is valid or not.

ISSUE 6

The Government argues that where the transaction is in whole or in part a sham or lacks economic substance, the legal expenses or fees paid or incurred to create the transaction are not deductible under §§ 162, 165 and 212.

Case law has generally precluded the deduction of out-of-pocket costs of investing in a sham transaction. In Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 279 (1999), aff'd, 254 F.3d 1313 (11th Cir. 2001), cert. denied, 535 U.S. 986 (2002), the court applied the sham transaction doctrine to disregard the transactions and then turned to the issue of whether administrative fees paid to the scheme's taxpayer were deductible. Those fees constituted expenses of the taxpayer that contributed to the overall "out-of-pocket" economic loss suffered by the taxpayer as a result of its investment in the sham transaction. The court summarily disallowed these fees, stating that, "[t]hey were incurred in connection with, and were an integral part of, a sham transaction and, as a result, are not deductible." Winn-Dixie Stores, Inc., 113 T.C. at 294. Thus, under this reasoning, if a transaction is determined to be a sham transaction, a taxpayer would not be entitled to any expenses incurred in connection therewith, even though those expenses reflected actual economic losses.

Similarly, in United States v. Wexler, 31 F.3d 117, 122 (3d Cir. 1994) cert. denied, 513 U.S. 1190 (1995), the Third Circuit stated, "Where a transaction has no substance other than to create deductions, the transaction is disregarded for tax purposes. Deductions for expenses resulting from such transactions are not permitted." (Internal citations omitted).

In several instances, individual tax shelter investors argued that they were entitled to deduct their "out-of-pocket" expenses on the basis that they suffered a theft loss pursuant to I.R.C. on § 165. The courts concluded that cash "investments" in limited partnerships designed to secure tax benefits are not theft losses. See, e.g., Viehweg v. Commissioner, 90 T.C. 1248 (1988); Marine v. Commissioner, 92 T.C. 958 (1989), aff'd, 921 F.2d 280 (9th Cir. 1991), cert. denied, 502 U.S. 819 (1991). The rationale is that the investors received what they bargained for – a tax shelter. See Marine, 92 T.C. at 978.

Other expenses, such as interest deductions on loans incurred in a transaction lacking economic substance, have not always been disallowed by the courts. There have been instances in which a court allowed an interest deduction on a loan that was part of a transaction that lacked economic substance. In Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 96 (4th Cir. 1985), the court allowed the taxpayer to deduct interest, finding that, although the transaction lacked economic substance, the taxpayer was still obligated to make payments on the recourse note. The court in ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998), cert. denied, 526 U.S. 1017 (1999), also allowed the taxpayer to deduct interest. There, the court found that the taxpayer had actual economic losses associated with the notes and held that the notes were not the "centerpiece" but were "separable from the sham aspects of the underlying transaction." ACM Partnership, 157 F.2d at 262.

Nonetheless, a number of cases have disallowed interest deductions where they were an integral part of a transaction found to lack economic substance. See Wexler v. United States, 31 F.3d 117, 125-26 (3d Cir. 1994), cert. denied, 513 U.S. 1190 (1995); Sheldon v. Commissioner, 94 T.C. 738 (1990); Saba Partnership v. Commissioner, T.C. Memo. 1999-359; Seykota v. Commissioner, T.C. Memo. 1991-541; Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967).

Sham transactions do not give rise to valid deductions or losses - even for the taxpayer's out-of-pocket cash investment. The only circumstances where some courts have permitted deductions related to sham transactions are where the deductions were attributable to separable economically substantive elements that were not the principal tax benefit of the underlying sham transactions. In the case of an individual or passthrough entity, there is a related alternative basis for disallowing shelter-related fees and similar costs. To deduct such costs under provisions such as §§ 162, 165, or 212, an individual must have a bona fide, primary profit motive independent of tax consequences. See Agro Science Co. v. Commissioner, 934 F .2d 573, 576 (5th Cir. 1991), cert. denied, 502 U.S. 907 (1991); Brown v. United States, 396 F .2d 459 (Ct. Cl. 1968); Price v. Commissioner, 88 T.C. 860, 886 (1987). These requirements also apply to partnerships at the entry level, determining the entity's motives by looking to those of its controlling individual or individuals. See Brannen v. Commissioner, 78 T.C. 471, 505 (1982), aff'd, 722 F .2d 695 (11th Cir. 1984).

In the majority of Notice 2003-47 transactions, it is likely that a court would uphold this decision upon a finding that the transaction is a sham or otherwise primarily motivated by tax avoidance rather than non-tax profit. In such case, recognition of income will be at the time of exercise. The executive will recognize compensation income as if he is the one to exercise the option. Moreover, the obligations are an integral and necessary element of these transactions since they are the tool used to defer the taxpayer's income. Generally, the litigating hazards with respect to the fees conform, by and large, to the hazards with respect to the underlying substantive issues in the shelter itself. If the Government prevails on issue 4, then it is likely that none of the expenditures associated with the Notice 2003-47 transaction would be allowable. In addressing the substantive shelter issues (§ 83), a court might refrain from characterizing all or part of the transaction as a sham, instead ruling against the taxpayer based on the interpretation of § 83 and the regulations thereunder.

We have addressed each component of the transaction costs separately. With regard to the deduction of legal expenses and fees under §§ 162 and 212, such expenditures can be classified as follows:

- Fees paid for the establishment of the Family Limited Partnership.
- Fees paid to obtain an appraisal of the options, and
- Fees paid to the promoter for the purported tax saving technique.

If the FLP was capitalized and was involved in other business activities, taxpayers may argue that the expenditures of creating the partnership are valid expenditures [redacted] # # # # # # These fees were paid to secure a valuation for the options. It may be argued that such a valuation was not needed or that it was a part of the steps required under the technique [redacted] # # #

That leaves the fees paid to the promoter for a tax avoidance technique [redacted] # # # # #

ISSUE 7

A separate determination must be made as to whether each transaction is subject to the disclosure rules under § 1.6011-4 based on the date the taxpayer entered into the transaction and which version of the regulations or temporary regulations was in effect at that time. Generally, however, the disclosure rules applicable to individuals, trusts, partnerships, and S corporations under § 1.6011-4 will apply if the individual, trust, partnership, or S corporation entered into the transaction on or after January 1, 2001, and the transaction was not reported on a tax return of the individual, trust, partnership, or S corporation that was filed on or before June 14, 2002. See § 1.6011-4T(g) (TD 9000, 67 FR 41324).

Thus, for all Notice 2003-47 transactions entered into by individuals, trusts, partnerships, or S corporations before January 1, 2001, there is no disclosure requirement under § 1.6011-4. For those transactions entered into on or after January 1, 2001, for which the transaction was reported on a return filed by June 14, 2002, there is also no disclosure requirement under § 1.6011-4. However, if the transaction is entered into on or after January 1, 2001, and the transaction was not reported on a return filed on or before June 14, 2002, the individual, trust, partnership, or S corporation is subject to the disclosure rules under § 1.6011-4 or § 1.6011-4T, as applicable. Those regulations also provide rules applicable for transactions that are subsequently identified as listed transactions.

If the taxpayer has an obligation to disclose the Notice 2003-47 transaction under § 1.6011-4 and the taxpayer failed to disclose the transaction to the Service, the failure to disclose the transaction is a factor that may affect the application of penalties in item 8.

ISSUE 8

Negligence

§ 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, or (2) any substantial understatement of income tax.

Whether the accuracy-related penalty applies to underpayments attributable to a Notice 2003-47 transaction must be determined on a case-by-case basis based upon the application of the legal standards for the penalty (as set forth in the Discussion § of this guideline) to the specific facts and circumstances of each taxpayer.

In cases where taxpayers can show disclosure under Announcement 2002-2 or that they filed a qualified amended return, the penalty may not be applicable.

Negligence

Negligence includes any failure to make 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. Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. Marcello v. Commissioner, 380 F.2d 499 (5th Cir. 1967). § 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.

Compliance argues that with respect to negligence, the ability to exclude income based upon a "sale" of the compensatory option to an entity made up entirely of immediate family members, where the option is exchanged for a long-term unsecured note, would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. This is especially true where no third parties were involved, and where the transaction occurred strictly through participation by the executive as a representative of both himself and the related person.

Accordingly, negligence is strongly indicated unless the executive demonstrates that he or she made a reasonable attempt to ascertain the correctness of the income exclusion.

Appeals opines 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 circumstance. A taxpayer who fails to demonstrate that he or she secured a tax opinion and had relied reasonably and in good faith on such an opinion would be subject to the full penalty applicable if there was no reasonable attempt to ascertain the correctness of the income exclusion.

Disregard of Rules and Regulations

Because the executive’s position with respect to Notice 2003-47 transactions does not involve a direct challenge to the validity of a particular rule or regulation (other than Notice 2003-47), it generally will be difficult to assert that the executive has disregarded rules or regulations for purposes of asserting the penalty for returns filed before July 2, 2003. However, for returns filed on or after July 2, 2003, the failure to include income due to Notice 2003-47 transactions would directly disregard the position set forth in the Notice, and accordingly serve as a basis for asserting penalties.

Substantial Understatement

For individual taxpayers, a substantial understatement of income tax exists for a taxable year if the amount of the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $ 5,000.

In calculating the understatement, the taxpayer is permitted a reduction for that portion attributable to “the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment,” or “any item if the relevant facts affecting the item’s treatment are 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.” However, in the case of any item of a taxpayer other than a corporation which is attributable to a tax shelter, no reduction is available for adequate disclosure and, to be entitled to a reduction on grounds of substantial authority for any item, the taxpayer must also have reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment. § 6662(d)(2)(C)(i)(I & II). The term “tax shelter” includes any plan or arrangement if a significant purpose of such is the avoidance or evasion of Federal income tax.

Compliance argues that the transactions at issue are tax shelters. § 6662(d)(2)(C)(iii). Appeals agrees that the Notice 2003-47 transaction is a tax shelter and, as such, no reduction in the understatement will be available unless there was substantial authority for the tax treatment of the item and the executive reasonably believed that it was more likely than not the proper treatment.

Compliance argues that the taxpayer involved in a 2003-47 transaction does not have substantial authority for his or her position. Accordingly, the substantial understatement penalty is applicable to most cases.

The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. § 1.6662-4(d)(2). It exists where the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. Weight is determined in light of the particular facts and circumstances of the case and the weight is accorded any particular authority depends on its relevance and persuasiveness. § 1.6662-4(d)(3)(ii). The definition of what constitutes "authority" is explained in § 1.6662-4(d)(3)(iii).

Executives involved in 2003-47 transaction pointed to no authority directly supporting either the claim that this type of transaction should be treated as an arm's length transaction or that the receipt of a deferred payment obligation under the circumstances of the transaction should result in the deferral of compensatory income for a long period of time.

Under § 1.83-7, the compensation option was not taxed at grant because it did not have a readily ascertainable FMV. The proposed treatment of the sale of compensatory option to a related person for an unfunded and unsecured deferred obligation as an arm's length transaction for purposes of § 1.83-7 renders meaningless the readily ascertainable FMV standard. That is because under the taxpayers' argument, the application of § 83 would be based solely upon the interested parties' valuation of the option, rather than whether the option has a readily ascertainable fair market value. Rather than reading the standard out of the regulation, the classification of the transfer as an arm's length transaction must consider the entirety of the facts and circumstances of the transfer.

The executives' analysis reflects the strategic use of sentences in certain authorities which, when taken in context, should be seen as reflecting the conclusion that the transfer of compensatory option in exchange for cash or other property results in compensation income, and not the broader propositions concluded by the executives. Similarly, the conclusion with respect to the deferral based upon the deferred payment obligation is problematic. The Tax Court's decision in Childs never addressed the application of § 1.83-7 to the transfer of a compensatory stock option.

In addition to demonstrating substantial authority, the taxpayer must have reasonably believed that the tax treatment of the item is more likely than not the proper tax treatment; § 1.6662-4(g)(1)(B). The taxpayer must show that he/she analyzed the pertinent facts and authorities in accordance with § 1.6662-4(d)(3)(2) and, based on this independent analysis, reasonably concluded in good faith, that there was a greater than 50 percent chance that the tax treatment of the item would be upheld if challenged by the Service. The taxpayer may also reasonably rely, in good faith, on the opinion of a professional advisor (§1.6662-4(g)(4)(i)(B)). The opinion must unambiguously state that, based on the advisor's analysis of the facts and authorities, there is a greater than 50 percent chance that the tax treatment will be upheld if the Service challenged the position. § 1.6662-4(g)(4)(I)(B). Morever, if the taxpayer is relying on advice to establish reasonable belief, the taxpayer must also meet the requirements generally applicable to relying on advice to establish good faith and reasonable cause [§ 1.6664-4(c) discussion to follow]. This standard will rarely be met where the advice relied upon is that of the promoter of the transaction.

In Notice 2003-47 transaction cases, taxpayers argue that they secured a tax opinion stating that the tax position taken is more likely than not the correct tax position. They argue that the transaction was conducted for the main purpose of family planning and asset protection. The tax was not avoided, but rather merely deferred. They also assert that their employer agreed to forgo deducting the amount they excluded until they report such income.

Appeals opines that taxpayers generally face greater hazards of litigation on the substantial authority and reasonable belief standard set forth in § 1.6662-4(g). It is our belief that the ultimate settlement of the penalty issue will rest with the reasonable cause exception that follows.

<u>The Reasonable Cause Exception</u>

The accuracy-related penalty (negligence, disregard of rules/regulations or substantial understatement) does not apply to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that the taxpayer acted in good faith. § 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on case-by-case basis, taking into account all pertinent facts and circumstances. § 1.6664-4(b)(1). All relevant facts, including the nature of the investment, the complexity of the tax issues, issues of independence of a tax advisor, and the sophistication of the taxpayer must be considered to determine whether there was reasonable cause and good faith

The following factors are relevant: the experience, knowledge and education of the taxpayer, whether the taxpayer obtained an opinion; the contents of such opinion; the timing of the receipt of the opinion in relation to the filing of the tax return; whether the opinion was given by a promoter; and any efforts to conceal the transaction, mislead the Service, or fail to cooperate in the examination of the transaction. These factors should be considered in connection with the settlement of the penalty raised.

Generally, if a taxpayer is alleging reliance upon written tax advice of a professional and is unwilling to produce a copy of the opinion letter, the taxpayer should not be relieved from penalty consideration. Moreover, an opinion letter prepared by a promoter should not be accorded significant weight. <u>Neonatology Associates v. Commissioner</u>, 115 T.C. 43 (2000), <u>aff'd</u>, 299 F.3d 221 (3rd Cir. 2002) (while good faith reliance on professional advice may establish reasonable cause, "reliance may be unreasonable when it is placed upon insiders, executives, 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."). In addition, if the taxpayer did not receive the opinion letter or discuss the transaction until after the return was filed; the taxpayer could not have reasonably relied on the opinion and thus, should not be relieved from penalties.

In most cases, the taxpayer secured a tax opinion from the promoter prior to filing their federal income tax return. It is this opinion that the taxpayer allegedly relied upon. In the typical 2003-47 transaction, the following facts are present: The FLP was created and the disposition of the stock option was completed shortly thereafter. Since the executive no longer owned the stock option upon exercise, he/she did not report income at the time of the exercise. Rather, they took the position that the compensatory income would not be recognized until the FLP paid a note in the future (15-30 years later). This may or may not have carried interest payments. The executive was a general partner and continued to control the activities of the FLP at the time of the exercise. The tax opinion alleged that the deferral was appropriate in accordance with § 83.

While Appeals believes that the taxpayer is faced with greater hazards of litigation in the reasonable cause issue, this issue does present hazards for the Service. [redacted] #
#
#
#

[redacted] # #

Where a taxpayer can point to an analysis of the tax consequences of the transaction prepared by an independent professional tax advisor that supports its position [one unrelated to the promoter], or its own contemporaneous analysis where the taxpayer had sufficient knowledge to reasonably believe that it could conduct such an analysis, the taxpayer may have made a reasonable attempt to properly assess his or her liability. In such cases, the penalty should be further reduced. The reduction should be based on an analysis of all facts presented including the taxpayer's experience, tax knowledge and education as well as the taxpayer's efforts to assess the proper tax. An executive who requested an opinion from an expert other than the promoter, to whom all facts and circumstances were disclosed (and no unreasonable assumptions), may be able to establish reasonable cause and good faith.

IThe positions taken by the taxpayers with respect to the Notice 2003-47 transaction included that the transaction would be treated as an arm's length transaction for purposes of § 1.83-7, and would not otherwise be successfully challenged under the Judicial Doctrines. As discussed earlier, certain significant factors may impact the assessment of litigation hazards with respect to the arm's length argument and the application of the Judicial Doctrines. Similarly, those same factors may impact the analysis of the litigation hazards with respect to whether the executive may establish reasonable cause and good faith. Accordingly, the penalty may be reduced further based on the strength of such factors. Appeals Officers should contact the coordinator if such factors are present.

The executive's education and background should also be considered. In situations indicating a failure to ascertain the correctness of the promoter's advice concerning the tax matters due to lack of sophistication, education, knowledge of taxation on the part of the taxpayer and a history of compliance, a reduction in the penalty may be warranted.

Also the penalty will not be applicable if the taxpayer can show reasonable cause for the position taken on their tax return. When fully developed facts clearly establish that a taxpayer has met the reasonable cause exception, the penalty should not be imposed.

[redacted] # # #