EFFECTIVE DATE: OCTOBER 15, 2004

COORDINATED ISSUE PAPER
ALL INDUSTRIES
"NOTICE 2002-21" TAX SHELTER
UIL NO: 9300.19-00

INTRODUCTION

On March 18, 2002, the Service issued Notice 2002-21, 2002-14 I.R.B. 730, announcing that the Service will challenge transactions that use a loan assumption agreement to claim an inflated basis in assets acquired from another party and identifying these transactions as listed transactions for purposes of §§ 6011, 6111, and 6112. Typically these transactions are arranged by a promoter, and in some cases were marketed as Custom Adjustable Rate Debt ("CARDS"). The transaction purportedly creates permanent tax deductions (either ordinary or capital losses) when a taxpayer becomes a co-obligor on a loan made to a third party, such as a limited liability company with foreign members ("LLC"). The Notice 2002-21 transaction creates an artificial loss that is used to offset other unrelated taxable income.

ISSUES

1. Whether the taxpayer's basis in the assets acquired from the LLC equals the full loan amount or the fair market value of the assets received on the acquisition date.

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

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

4. Whether the provisions of I.R.C. § 988 limit any foreign currency losses claimed.

5. Whether the purported loan to the LLC constitutes genuine indebtedness for Federal income tax purposes.

6. Whether the purported losses may be disallowed because the Notice 2002-21 transaction as a whole lacks economic substance and business purpose apart from tax savings.

7. Whether the Service should assert the appropriate I.R.C. § 6662 accuracy-related penalties against taxpayers who entered into the "Notice 2002-21" transactions.

SUMMARY OF CONCLUSIONS

1. The taxpayer's basis in the assets acquired from the LLC is limited to the fair market value of the assets received as of the date of acquisition.

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

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

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

5. The purported loan to the LLC does not constitute genuine indebtedness, and therefore the taxpayer's subsequent assumption of that indebtedness has no effect for Federal income tax purposes.

6. The taxpayer's loss is disallowed because the Notice 2002-21 transaction as a whole lacks economic substance and business purpose apart from tax savings.

7. Depending on the facts of each transaction, and on a case-by-case basis, the Service should consider asserting the applicable I.R.C. § 6662 accuracy-related penalties.

FACTS

The standard transaction involves a taxpayer with substantial taxable income to shelter. The taxpayer takes part in the following planned series of steps, which were arranged through a promoter, in an attempt to create an artificial loss to offset its taxable income:[1]

1. Formation of LLC

First, the promoter creates a special purpose limited liability company ("LLC"). The LLC members are two nonresident alien individuals. The initial capital contribution to the LLC consists of recourse notes from the members.

2. Origination of Loan - Credit Agreement

The LLC enters into a thirty-year balloon loan agreement with a bank (the "credit agreement"). The balloon loan, which is also called a bullet loan, is a long-term loan that has one principal payment due at maturity coupled with periodic interest payments. The loan is usually denominated in Euros or another foreign currency. The borrowing may also be structured using U.S. dollars to accommodate taxpayers who are seeking to shelter capital gain income. Under the terms of the credit agreement, interest on the loan is payable annually and accrues at a rate based on a formula tied to the London

[1] The described transaction is the typical transaction. Specific transactions might involve nonmaterial variations. For example, the initial borrowing need not be made by an LLC.

Inter-Bank Offer Rate ("LIBOR"), which is the interest rate that the largest international banks charge each other for loans. The interest rate is usually re-set on an annual basis. The loan may be repaid without premium or penalty on or after the first interest re-set date. The LLC has the right to assign its obligations under the credit agreement to another party as co-obligor subject to the approval of the lending bank.

3. Establishment of Collateral Account

The LLC is required to deposit the loan proceeds plus an additional amount of cash into a collateral account subject to a lien in favor of the lending bank who acts as the account custodian. The interest earned on collateral provides the source of funds to pay the annual interest accrual on the balloon loan. The security agreement specifies that the collateral must be invested in certificates of deposit, short term deposits, highly rated commercial paper or government securities. The collateral is segregated into two separate time deposit accounts. Eighty-five percent of the collateral is invested in one time deposit account, and the remaining fifteen percent is deposited in a separate account. The second account (15% of collateral account) appears to represent the present value of the principal amount due in thirty years calculated using the prevailing market rate of interest as of the loan origination date.

4. Sale to Taxpayer as Co-Obligor

The taxpayer acquires 15% of the total collateral ("conveyed assets") from the LLC in exchange for becoming jointly and severally liable as a co-obligor under the credit agreement with the Bank. Pursuant to the purchase agreement between the LLC and taxpayer, the LLC and taxpayer determine how the parties will be responsible for the loan payments. The LLC agrees to make all interest payments under the credit agreement, and the taxpayer agrees to pay the principal due under the loan at maturity. The parties also agree to waive their respective rights of contribution against each other under local State law. At the time of the purchase agreement, the taxpayer executes a pledge and security agreement with the lending bank and deposits the conveyed assets into a collateral account.

5. Disposition of Conveyed Assets

Finally, the taxpayer disposes of the conveyed assets for their fair market value. The taxpayer takes the position that its basis in the conveyed assets (as a result of its loan assumption) is the entire loan amount. Therefore, the taxpayer reports a loss for Federal income tax purposes in an amount equal to the excess of the stated principal amount of the loan over the fair market value of the conveyed assets. If the original loan is denominated in U.S. currency, the taxpayer claims a capital loss. If the original loan is denominated in a foreign currency (usually Euros), the taxpayer claims an ordinary loss.

As noted, the underlying loan to LLC typically provides for a periodic resetting of the interest rate. If the parties fail to agree to continue the loan at the new rate, the loan will

be repaid. In the typical Notice 2002-21 transaction, the loan is repaid with property held in the collateral accounts of LLC and taxpayer, shortly after the loss recognition event, at the next reset date.

DISCUSSION

1. The taxpayer's basis in the assets acquired from LLC is limited to their fair market value.

I.R.C. § 1012 provides that the basis of property is equal to the cost of the property. Treas. Reg. § 1.1012-1(a) defines "cost" to mean the "amount paid" for the property in cash or other property. Under general tax law principles, the amount paid for property generally includes the amount of the seller's liabilities assumed by the buyer. Commissioner v. Oxford Paper Co., 194 F.2d 190 (2d Cir. 1952). The premise for characterizing liabilities assumed by the buyer as amounts paid by the buyer is that the buyer will pay the liabilities in full. Commissioner v. Tufts, 461 U.S. 300, 308 (1983). That rationale is absent in Notice 2002-21 transactions.

In appropriate cases, courts have rejected attempts to assign an inflated basis to property and have limited the basis of property to its fair market value. For example, the basis of property acquired with the issuance or assumption of recourse indebtedness has been limited to the acquired property's fair market value where "a transaction is not conducted at arm's-length by two economically self-interested parties or where a transaction is based upon 'peculiar circumstances' which influence the purchaser to agree to a price in excess of the property's fair market value." Lemmen v. Commissioner, 77 T.C. 1326, 1348 (1981); Bixby v. Commissioner, 58 T.C. 757, 776 (1972); Webber v. Commissioner, T.C. Memo. 1983-633, aff'd, 790 F.2d 1463 (9th Cir. 1986). See also Majestic Securities Corp. v. Commissioner, 42 B.T.A. 698, 701 (1940), aff'd, 120 F.2d 12 (8th Cir. 1941) ["The general rule that the price paid is the basis for determining gain or loss on future disposition presupposes a normal business transaction."]

Other cases have limited the portion of an assumed indebtedness that may be taken into account for Federal income tax purposes. For example, where two or more persons are liable on the same indebtedness, or hold separate properties subject to the same indebtedness, the amount taken into account for Federal income tax purposes by each person generally is based on all the facts and circumstances, including the economic realities of the situation and the parties' expectations as to how the liabilities will be paid. See Maher v. United States, No. 16253-1 (W.D. Mo. 1969) [Property was not in substance "subject to" liability where lender was not actually relying on property as collateral]; Maher v. Commissioner, 469 F.2d 225 (8th Cir. 1972) [Corporation's assumption of primary liability on shareholder's indebtedness becomes taxable dividend only as corporation makes payments as promised]; Snowa v. Commissioner, T.C. Memo 1995- 336, rev'd on other grounds, 123 F.3d 190 (4th Cir. 1997) [Co-obligor's cost of a new residence included only her ratable share of the liability due to state law's right of contribution].

In the absence of direct authority, a supportable method of allocating basis looks to the amount of the total debt that each co-obligor can be expected to pay. In the "Notice 2002-21" transaction, as a matter of economic reality, the parties by agreement have bifurcated the loan into two parts: (1) interest with the LLC as the primary obligor and thus expected to pay; and (2) principal with the taxpayer as the primary obligor and thus expected to pay. Each will bear responsibility for repayment of the loan in accordance with their relative ownership of the assets immediately following the transfer from LLC to the taxpayer. Accordingly, the taxpayer's basis in the assets is equal to the fair market value of such assets upon their acquisition by taxpayer, i.e. the taxpayer's basis should be limited to the fair market value of the assets received rather than the full loan amount.

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

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

Here, the transactions are no more than a series of contrived steps designed to create an inflated basis in the conveyed assets purportedly equal to the principal amount of the loan plus any consideration paid to the LLC. The inflated basis, in turn, generates an artificial loss upon the taxpayer's disposition of the conveyed assets. The taxpayer has suffered no real economic loss because that disposition constitutes an economically inconsequential investment, with the taxpayer effectively returning to the same economic position as before. See ACM Partnership v. Commissioner, 157 F.3d at 251-252. Accordingly, the loss is not allowable under § 165.

Furthermore, § 165(c) disallows the loss for an individual taxpayer. The "loss" in this transaction is not incurred in a trade or business or from a casualty or theft, within the meaning of §§ 165(c)(1) and (3). Therefore, a loss in this transaction is only allowable for an individual if it is incurred in a transaction undertaken for profit. I.R.C. § 165(c)(2);

Fox v. Commissioner, 82 T.C. 1001 (1984); Smith v. Commissioner, 78 T.C. 350 (1982). For the loss to be allowable, a profit motive must be the taxpayer's primary motive for engaging in the transaction. Fox, 82 T.C. at 1020-21 (citing Helvering v. Nat'l Grocery Co., 304 U.S. 282, 289 n.5 (1938)).

A taxpayer's potential profit from this transaction, apart from tax savings, is minimal at best. The taxpayer could profit from this transaction only if the value of the assets in the taxpayer's 15% collateral account exceeded the amount of the obligation they secure, either upon maturity of the loan, or at an earlier time if the disposition occurs prior to maturity. However, the value of the collateral assets is equal to the present value of the amount necessary to pay the loan principal at maturity. The collateral funds are required to be invested in safe investments such as certificates of deposit, short term deposits, highly rated commercial paper, or government securities. Because of the rate of return expected in connection with these safe investments, there is little possibility that the collateral would exceed the loan amount. Reducing even further the possibility of profit is the short-term nature of the transaction – the underlying loan is typically repaid at the first interest reset date – and the large upfront transaction costs paid by the taxpayer. Consequently, it is unlikely that a taxpayer can demonstrate a reasonable expectation to earn more than minimal profit from this transaction, apart from tax savings. See Knetsch v. United States, 348 F.2d 932, 938 (Ct. Cl. 1965) ("[T]he statutory word 'profit' [under § 165(c)(2)] cannot embrace profit seeking activity in which the only economic gain derived therefrom results from a tax reduction."). Therefore, the loss is disallowed by § 165(c)(2).

3. The taxpayer's loss may be limited by the I.R.C. § 465 at-risk provisions.

I.R.C. § 465 generally limits deductions for losses in certain activities to the amount for which the taxpayer is at-risk. In the case of an individual taxpayer or a C corporation with respect to which the stock ownership requirement of paragraph (2) of § 542(a) is met (after applying the attribution rule in § 544(a)), § 465 limits the taxpayer's losses to the amount for which the taxpayer is at risk in the activity. I.R.C. § 465(a)(1). Section 465 applies to all activities engaged in by the taxpayer in carrying on a trade or business or for the production of income. I.R.C. § 465(c)(3)(A). Under those sections, losses incurred in an activity engaged in by a taxpayer carrying on a trade or business or for the production of income is defined broadly to include "excess of the allowable deductions allocable to the activity over the income received or accrued by the taxpayer during the taxable year from the activity." Lansburgh v. Commissioner, 92 T.C. 448, 454-55 (1989). This interpretation is supported by the legislative history of § 465 which provides that the at-risk limitation applies to losses "regardless of the kind of deductible expenses which contributed to the loss." S. Rept. 94-938, at 48 (1976), 1976-3 C.B. (Vol.3) 86. In this case, section 465 applies to the loss stemming from taxpayer's purchase of assets.

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

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

The case law, however, is not in complete accord on this issue. In Emershaw v. Commissioner, 949 F.2d 841, 845 (6th Cir. 1991), the court adopted a worst-case scenario approach and determined that the issue of whether a taxpayer is "at risk" for purposes of I.R.C. § 465(b)(4) "must be resolved on the basis of who realistically will be the payor of last resort if the transaction goes sour and the secured property associated with the transaction is not adequate to pay off the debt." quoting Levy v. Commissioner, 91 T.C. 838, 869 (1988). In contrast, the Second, Eighth, Ninth, and Eleventh Circuits look to the underlying economic substance of the arrangements under I.R.C. § 465(b)(4). Waters v. Commissioner, 978 F.2d 1310, 1316 (2d Cir. 1992) (citing American Principals Leasing Corp v. United States, 904 F.2d 477, 483 (9th Cir. 1990); Young v. Commissioner, 926 F.2d 1083, 1089 (11th Cir. 1991); Moser v. Commissioner,

914 F.2d at 1048-49.) The view, as adopted by the Second, Eighth, Ninth, and Eleventh Circuits is that, in determining who has the ultimate liability for an obligation, the economic substance and the commercial realities of the transaction control. See Waters v. Commissioner, 978 F.2d at 1316; Levien v. Commissioner, 103 T.C. 120; Thornock v. Commissioner, 94 T.C. 439, 448 (1990); Bussing v. Commissioner, 89 T.C. 1050, 1057 (1987). To determine whether a taxpayer is protected from ultimate liability, a transaction should be examined to see if it "is structured, by whatever method, to remove any realistic possibility that the taxpayer will suffer an economic loss if the transaction turns out to be unprofitable." American Principals Leasing Corp. v. United States, 904 F.2d at 483; see Young v. Commissioner, 926 F.2d at 1088; Thornock v. Commissioner, 94 T.C. at 448-49; Owens v. United States, 818 F.Supp. 1089, 1097 (E.D. Tenn. 1993); Bussing v. Commissioner, 89 T.C. at 1057-58. "[A] binding contract is not necessary for [I.R.C. § 465(b)(4)] to apply." American Principals Leasing Corp. v United States, 904 F.2d at 482-83. In addition, "the substance and commercial realities of the financing arrangements presented . . . by each transaction" should be taken into account under I.R.C. § 465(b)(4). Thornock v. Commissioner, 94 T.C. at 449. To avoid the application of I.R.C. § 465(b)(4), there must be more than "a theoretical possibility that the taxpayer will suffer economic loss." American Principals Leasing Corp. v United States, 904 F.2d at 483.

In the typical "Notice 2002-21" transaction, both the LLC and the taxpayer are required to leave the "borrowed funds" in accounts with the bank unless the taxpayer obtains permission to invest them in limited types of investments, which must also be left with the bank. The loan is fully collateralized by money or other property on deposit with the bank. Accordingly, I.R.C. § 465(b)(4) limits the taxpayers at-risk amount to the consideration paid to the LLC without regard to the co-obligor agreement.

It should be noted in applying the at-risk rules to a qualified C corporation that meets the ownership requirements of § 542(a), discussed above, that § 465(c)(7) provides an exception to the application of the at-risk rules for a corporation that is (1) qualified C corporation and (2) conducts a qualifying business. A qualified C corporation is one that is not a personal holding company under § 542(a), a foreign personal holding company under § 552(a), or a personal service corporation under § 269A(b) but determined by substituting "5 percent" for "10 percent" in § 269A(b)(2). A qualifying business is an active business that during the entire 12-month period ending on the last day of the taxable year had (1) at least 1 full-time employee substantially all the services of whom were in the active management of the business, (2) 3 full-time non-owner employees substantially all of the services of whom were services directly related to the business, (3) the amount of deductions attributable to such business which are allowable to the taxpayer solely by reason of §§ 162 and 404 for the taxable year exceeds 15 percent of the gross income from such business for such year, and (4) such business is not an excluded business. If the corporation is a member of an affiliated group, then under § 465(c)(7)(F), the affiliated group is treated as a single taxpayer.

Finally, it is also notable that under § 1.1502-45(a)(2) of the regulations a subsidiary's loss is includable in the computation of consolidated taxable income and consolidated

capital gain net income of its parent only in the amount that its parent is at risk in the activity at the close of the taxable year. Under § 1.1502-45(a)(3), a parent's amount at risk in an activity is the lesser of (i) the amount that the parent is at risk in the subsidiary or (ii) the amount the subsidiary is at risk in the activity.

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

I.R.C. §§ 985-989, which were enacted as part of the Tax Reform Act of 1986, set forth a comprehensive set of rules for the treatment of foreign currency transactions.[2] I.R.C. § 988(a)(1)(A) provides that foreign currency gain or loss attributable to an I.R.C. § 988 transaction is computed separately and treated as ordinary income or loss. Foreign currency gain on an I.R.C.§ 988 transaction is generally defined as the gain on the transaction to the extent such gain does not exceed gain realized by reasons of changes in exchange rates on or after the booking date and before the payment date. I.R.C. § 988(b)(1). Foreign currency loss is similarly defined in I.R.C. § 988(b)(2). In this manner, Congress intended that only gain or loss to the extent it is realized by reason of a change in exchange rates between the date the asset or liability is taken into account for tax purposes and the date it is paid or otherwise disposed of, will be treated as foreign currency gain or loss. S. Rep. No. 313, 99th Cong., 2d Sess. 461 (1986). In addition, any gain or loss from the disposition of nonfunctional currency is treated as foreign currency gain or loss under the assumption that any gain or loss realized on the disposition of nonfunctional currency must be attributable to the fluctuation in the foreign exchange rates between the purchase and sale of the currency. I.R.C. § 988(c)(1)(C)(i). This is confirmed by committee reports describing the principles of § 988 prior to its amendment to address issues not implicated in the Notice 2002-21 cases by the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). Thus, the House Ways and Means Committee Report to the Miscellaneous Revenue Act of 1988 stated that "[i]n the case of any disposition of nonfunctional currency, the relevant period for measuring rate changes is the time between acquisition and disposition of the currency." H.R. Rep. No. 795, 100th Cong., 2d Sess. 296 (1988).

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

[2] The following discussion assumes that the taxpayer is a corporation. If the taxpayer is an individual, §988 will only apply if the provisions of §988(e) are satisfied.

policies of § 988." H.R. Rep. No. 795, 100th Cong., 2d Sess. 296 (1988); S. Rep. No. 445, 100th Cong., 2d Sess. 311 (1988) (containing identical language).

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

In this case, the transaction at issue may be recharacterized in accordance with its substance with the taxpayer's artificial loss being disallowed under Treas. Reg. § 1.988-2(f). For purposes of I.R.C. § 988, the substance of the transaction may be viewed as a loan from the Foreign Bank to the LLC followed by the taxpayer borrowing part of the original loan proceeds indirectly through a zero coupon loan. The computation of taxpayer's foreign currency loss does not reflect the substance of the transaction because the claimed loss is not the result of exchange rate fluctuations but rather from the overstated cost basis in the loan proceeds. Accordingly, consistent with Treas. Reg. § 1.988-2(f), the taxpayer is not entitled to deduct its artificial I.R.C. § 988 loss.

Alternatively, the loss may be excluded from I.R.C.§ 988 under Treas. Reg. § 1.988-1(a)(11) because the purported loss is totally unrelated to the fluctuation of foreign currency rates. Excluding the transaction from section 988 will result in a capital loss. Barnes Group v. United States, 697 F. Supp 591 (D. Conn. 1988).

5. The purported loan to the LLC does not constitute genuine indebtedness, and therefore the taxpayer's subsequent assumption of that indebtedness has no effect for Federal income tax purposes.

A loss is allowable as a deduction for Federal income tax purposes only if it is bona fide and reflects actual economic consequences. See generally, Gregory v. Helvering, 293 U.S. 465 (1935); Freytag v. Commissioner, 904 F.2d 1011, 1015 (5th Cir. 1990). In certain circumstances, courts will recognize that even if a transaction actually does occur, that transaction may be lacking in economic substance. Lerman v. Commissioner, 939 F.2d 44, 49 n.6 (3d Cir. 1991). See also, Yosha v. Commissioner, 861 F.2d 494, 500 (7th Cir. 1988).

For instance, with respect to transactions involving loans, "it is well settled that the mere fact that a note is given does not prove the existence of a loan where there was no indebtedness existing which the note evidenced." Leonard v. Commissioner, T.C. Memo. 1985-51, citing Elbert v. Commissioner, 45 B.T.A. 685 (1941), and Golsen v. Commissioner, 54 T.C. 742, 754 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971). In

Knetsch v. Commissioner, 364 U.S. 361 (1960), the Supreme Court held that a loan transaction entered into by a taxpayer may be disregarded for tax purposes if there was no genuine indebtedness. The Supreme Court held that no valid indebtedness existed where the taxpayer never acquired a meaningful beneficial interest in the loan. In Bridges v. Commissioner, 39 T.C. 1064, aff'd, 325 F.2d 180 (4th Cir. 1963), a taxpayer purportedly borrowed funds from banks to buy Treasury notes and bonds which were pledged as collateral to secure the loans with the proceeds upon maturity or resale being applied to the repayment of the loans. The court described the transaction as merely providing the "facade" of a loan because the taxpayer never had control of the funds purportedly borrowed or the collateral (the Treasury notes and bonds), and the collateral amply secured the purported loan.

In the typical "Notice 2002-21" transaction, the facts and circumstances of the loan transaction support the conclusion that the credit arrangement lacks economic substance.[3] On the original loan date, the lender purportedly transferred funds to the borrower. Contemporaneously with this "transfer", however, the entire loan proceeds were then deposited into a collateral account held by the lender. Per the loan agreement, the borrower assigned all its rights in the collateral account back to the lender. Therefore, borrower never obtained unfettered use of or control over the borrowed funds.

Similarly, the transfer of a portion of the loan proceeds to the taxpayer pursuant to the subsequent loan assumption agreement mirrors the same circular flow described above. Here, the typical taxpayer "acquires" approximately 15% of the loan amount, and again the entire amount is re-deposited with the original lender. The taxpayer is also required to assign all of its rights in this second collateral account to the lender. The only substantive change following taxpayer's assumption is that a portion of the loan collateral has been transferred to the taxpayer's collateral account from one of the LLC's collateral accounts.

Usually when the collateral accounts are established, the original borrower and the assuming party are required to deposit additional collateral into their respective accounts. The total collateral deposits (loan proceeds, additional collateral, plus any accrued interest) provide funds sufficient to satisfy interest payments as they become due on the loan through the first re-set date. Accordingly, the loan is fully collateralized and economically defeased up to that point. In substance, the bank never relinquishes control of the "borrowed" funds and is protected from any credit risk because it holds sufficient funds in the collateral accounts to satisfy the loan obligations. The bank simply makes offsetting bookkeeping entries debiting the appropriate amount from the collateral accounts and applying these funds to pay the interest due on the loan. At no time does the original borrower (or the taxpayer) obtain the uncontrolled use of any additional money as a result of the credit agreement. Since the borrower incurs no

[3] This argument must be supported by facts showing that neither LLC nor taxpayer obtained use of "borrowed" funds. Such facts would include lack of control over property held in the collateral accounts and the inability to substitute collateral.

genuine indebtedness, the purported assumption of such indebtedness by taxpayer has no effect for tax purposes.

6. The taxpayer's loss is disallowed because the Notice 2002-21 transaction as a whole lacks economic substance and business purpose apart from tax savings.

To be respected for tax purposes, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits, which were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 2001), aff'g, 113 T.C. 254 (1999); United States v. Wexler, 31 F.3d 117, 122, 124 (3rd Cir. 1994); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g, Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2nd Cir. 1966), aff'g, 44 T.C. 284 (1965); Weller v. Commissioner, 31 T.C. 33 (1958), aff'd, 270 F.2d 294 (3rd Cir. 1959); Nicole Rose Corp. v. Commissioner, 117 T.C. No. 27 (2001); ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part, 157 F.3d 231 (3rd Cir. 1998).

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3d Cir. 1998); Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction has economic substance, apart from its tax consequences. ACM Partnership v. Commissioner, 157 F.3d at 247; Casebeer v. Commissioner, 909 F.2d at 1363.

Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. Knetsch v. United States, 364 U.S. 361 (1960). In Knetsch, the taxpayer repeatedly borrowed against increases in the cash value of a bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found that the transaction had no substance, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

In Sheldon v. Commissioner, 94 T.C. 738 (1990), the Tax Court denied the taxpayer the tax benefits of a series of Treasury bill sale-repurchase transactions because they lacked economic substance. In the transactions, the taxpayer bought Treasury bills that matured shortly after the end of the tax year and funded the purchase by borrowing against the Treasury bills. The taxpayer accrued the majority of its interest deduction on the borrowings in the first year while deferring the inclusion of its economically offsetting interest income from the Treasury bills until the second year. The transactions lacked economic substance because the economic consequence of

holding the Treasury bills was largely offset by the economic cost of the borrowings. The taxpayer was denied the tax benefit of the transactions because the real economic impact of the transactions was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions." Sheldon v. Commissioner, 94 T.C. at 769.

In ACM Partnership, the taxpayer entered into a near-simultaneous purchase and sale of debt instruments. Taken together, the purchase and sale "had only nominal, incidental effects on [the taxpayer's] net economic position." ACM Partnership v. Commissioner, 157 F.3d at 250. The taxpayer claimed that, despite the minimal net economic effect, the transaction had economic substance. The court held that transactions that do not "appreciably" affect a taxpayer's beneficial interest, except to reduce tax, are devoid of substance and are not respected for tax purposes. Id. at 248. The court denied the taxpayer the purported tax benefits of the transaction because the transaction lacked any significant economic consequences other than the creation of tax benefits. But Cf. Compaq Computer Corp v. Commissioner, 277 F.3d 778 (5th Cir. 2001), 2002-1 USTC ¶ 50,144, rev'g, 113 T.C. 214 (1999) [stating that a "taxpayer's subjective intent to avoid taxes ... will not by itself determine whether there was a business purpose to a transaction" and that steps to avoid risk may show "good business judgment consistent with a subjective intent to treat … trade as a money-making transaction."]

Even if the purported loan to the LLC constitutes genuine indebtedness of the LLC, it likely can be shown that the Notice 2002-21 transaction lacks economic substance. Facts indicating that the transaction fails the objective prong of the economic substance test include large transaction costs that the taxpayer is unlikely to recover given the small, if any, spread between earnings on collateral and the interest rate on the underlying loan, lack of control over the property pledged as collateral and an inability to substitute collateral, and the short period of time before the transaction is terminated through repayment of the loan. These facts all demonstrate lack of any reasonable potential for pre-tax profit.[4]

Generally, the transaction also fails the subjective economic substance prong. Typically, the taxpayer has significant taxable income (either capital gain income or ordinary income) unrelated to the transaction. Through participation in this transaction, the taxpayer is able to choose the character and amount of the loss needed to offset the unrelated income. The close connection between the taxable income being sheltered and the claimed loss suggests that the taxpayer did not enter into this transaction for a business purpose. As the Tenth Circuit has recognized, "correlation of losses to tax needs coupled with a general indifference to, or absence of, economic profits may reflect a lack of economic substance." Keeler v. Commissioner, 243 F.3d 1212, 1218 (10th Cir. 2001), citing Freytag v. Commissioner, 89 T.C. 849, 877-878 (1987). Here, the taxpayer could have borrowed funds directly from a financial institution. Instead, with the assistance of a tax shelter promoter, the taxpayer chose to acquire its

[4] Facts demonstrating that a transaction lacks any reasonable possibility of pre-tax profit should be developed prior to arguing lack of economic substance.

investment in such a manner as to exploit the assumption of liability rules. There was no useful non-tax purpose for entering into this structured transaction and certain steps thereto other than the creation of an artificial tax loss. In conclusion, there is no practical economic effect from the transaction, in whole or in part, other than the creation of a loss to offset unrelated taxable income. Accordingly, any tax benefits, fees or expenses, related thereto, may be disallowed because the Notice 2002-21 transaction as a whole lacks economic substance and business purpose apart from tax savings.

7. Depending on the facts of each transaction, and on a case-by-case basis, the Service should consider asserting the applicable I.R.C. § 6662 accuracy-related penalties.

Section 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment[5] attributable to, among other things: (1) negligence or disregard of rules or regulations, (2) any substantial understatement of income tax, and (3) any substantial valuation misstatement under chapter 1. Treas. Reg. § 1.6662-2(c) provides that there is no stacking of the accuracy-related penalty components. Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20 percent (40 percent in the case of a gross valuation misstatement), even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial valuation misstatement). See D.H.L. Corp. v. Commissioner, T.C. Memo. 1998-461, aff'd in part and rev'd on other grounds, remanded by, 285 F.3d 1210 (9th Cir. 2002) (The Service alternatively determined that either the 40-percent accuracy-related penalty attributable to a gross valuation misstatement under I.R.C. § 6662(h) or the 20-percent accuracy-related penalty attributable to negligence was applicable).

NEGLIGENCE OR DISREGARD OF RULES OR REGULATIONS

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 I.R.C. § 6662(c) and Treas. Reg. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499 (5th Cir. 1967), aff'g, 43 T.C. 168 (1964); Neely v. Commissioner, 85 T.C. 934, 947 (1985). Treas. Reg. § 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. If, therefore, a taxpayer reported losses from a transaction that lacked economic substance without making a reasonable attempt to ascertain the correctness of the claimed losses, then the accuracy related penalty attributable to negligence may be

[5] 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 I.R.C. § 6664(a).

appropriate. For example, in Compaq v. Commissioner, 113 T.C. 214 (1999), rev'd on other grounds, 277 F.3d 778 (5th Cir. 2001), the Service argued that Compaq was liable for the accuracy-related penalty because Compaq disregarded the economic substance of the transaction. The court agreed with the Service's position and asserted the accuracy-related penalty for negligence because Compaq failed to "investigate the details of the transaction, the entity it was investing in, the parties it was doing business with, or the cash-flow implications of the transaction." Compaq v Commissioner, 113 T.C. at 227.

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

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

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

SUBSTANTIAL UNDERSTATEMENT

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

from an item attributable to a tax shelter. For purposes of § 6662(d)(2)(C), a tax shelter is a partnership or other entity, an investment plan or arrangement, or other plan or arrangement where a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax. I.R.C. § 6662(d)(2)(C)(iii). Because the purpose of the Notice 2002-21 plan is tax avoidance, it is a tax shelter pursuant to section 6662(d)(2)(C). Different rules apply however, depending upon whether the taxpayer is a corporation or an individual or entity other than a corporation.

In the case of any item of a taxpayer other than a corporation, which is attributable to a tax shelter, understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority[6] for such treatment, if (2) the taxpayer reasonably believed that the tax treatment of the item was more likely than not the proper treatment. I.R.C. § 6662(d)(2)(C)(i). A taxpayer is considered to have reasonably believed that the tax treatment of an item is more likely than not the proper tax treatment if (1) the taxpayer analyzes the pertinent facts and authorities, and based on that analysis reasonably concludes, in good faith, that there is a greater than fifty-percent likelihood that the tax treatment of the item will be upheld if the Service challenges it, or (2) the taxpayer reasonably relies, in good faith, on the opinion of a professional tax advisor, which clearly states (based on the advisor's analysis of the pertinent facts and authorities) that the advisor concludes there is a greater than fifty percent likelihood the tax treatment of the item will be upheld if the Service challenges it. Treas. Reg. § 1.6662-4(g)(4).

It is well established that taxpayers generally cannot "reasonably rely" on the professional advice of a tax shelter promoter. See Neonatology Associates, P.A., v. Commissioner, 299 F.2d 221 (3rd Cir. 2002) (citing Ellwest Stereo Theatres of Memphis, Inc. v. Commissioner, T.C. Memo. 1995-610). ("Reliance may be unreasonable when it is placed upon insiders, promoters, or their offering materials, or when the person relied upon has an inherent conflict of interest that the taxpayer knew or should have known about."); Goldman v. Commissioner, 39 F.3d 402, 408 (2d Cir. 1994) ("Appellants cannot reasonably rely for professional advice on someone they know to be burdened with an inherent conflict of interest."), aff'g, T.C. Memo 1993-480; Marine v. Commissioner, 92 T.C. 958, 992-993 (1989), aff'd without published opinion, 921 F.2d 280 (9th Cir. 1991). Such reliance is especially unreasonable when the advice would seem to a reasonable person to be "too good to be true". Pasternak v. Commissioner, 990 F.2d 893, 903 (6th Cir. 1993), aff'g, Donahue v. Commissioner, T.C. Memo. 1991-181; Gale v. Commissioner, T.C. Memo. 2002-54; Elliott v. Commissioner, 90 T.C. 960, 974 (1988), aff'd without published opinion, 899 F.2d 18 (9th Cir. 1990); Treas. Reg. §

[6] 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. Treas. Reg. 1.6662-3(d)(i). On the basis of the substantive discussion of the Notice 2002-21 transaction in the foregoing pages of this document, it is unlikely that the transaction would meet the substantial authority test.

1.6662-3(b)(2). Thus, if the taxpayer claimed to have relied on a tax opinion from a promoter, the understatement penalty would likely apply. Further, if the taxpayer did not receive the opinion until after filing the return, the taxpayer could not have relied upon the tax opinion in taking a position on the return. Thus, the understatement could not be reduced.

In the case of items of corporate taxpayers no provision applies to reduce the understatement on the basis of the taxpayer's position or disclosure of items. I.R.C. § 6662(d)(2)(C)(ii). Therefore, if a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item (such as a Notice 2002-21 transaction), the accuracy related penalty applies to the underpayment arising from the understatement unless the reasonable cause and good faith exception applies.

SUBSTANTIAL VALUATION MISSTATEMENT

For the accuracy-related penalty attributable to a substantial valuation misstatement to apply, the portion of the underpayment attributable to a substantial valuation misstatement must exceed $5,000 ($10,000 for a corporation, other than an S corporation or a personal holding company). I.R.C. § 6662(e)(2).

A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such value or adjusted basis. I.R.C. § 6662(e)(1)(A). If the value or adjusted basis of any property claimed on a return is 400 percent or more of the amount determined to be the correct amount of such value or adjusted basis, the valuation misstatement constitutes a "gross valuation misstatement." I.R.C. § 6662(h)(2)(A). If there is a gross valuation misstatement, then the 20 percent penalty under I.R.C. § 6662(a) is increased to 40 percent. I.R.C. § 6662(h)(1). One of the circumstances in which a valuation misstatement may exist is when a taxpayer's claimed basis is disallowed for lack of economic substance. See Gilman v. Commissioner, 933 F.2d 143 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992) (applying § 6659, repealed and replaced by § 6662); Zfass v. Commissioner, 118 F.3d 184 (4th Cir. 1997), aff'g, T.C. Memo. 1996-167; Illes v. Commissioner, 976 F.2d 733 (6th Cir. 1992), aff'g, T.C. Memo. 1991-449; Massengill v. Commissioner, 876 F.2d 616 (8th Cir. 1989, aff'g, T.C. Memo. 1988-427. But see Gainer v. Commissioner, 893 F. 2d 225 (9th Cir. 1990); Todd v. Commissioner, 862 F.2d 540 (5th Cir. 1988). (The Courts viewed the underpayment as attributable to an improper deduction, not a valuation misstatement). If the taxpayer's claimed basis in the assets is 200 percent or more of the correct amount, then a substantial valuation misstatement exists; if the claimed basis in the assets is 400 percent or more of the correct amount, then a gross valuation misstatement exists. In many cases, the basis overstatement will be of such a magnitude that a gross valuation misstatement penalty will be appropriate pursuant to section 6662(h).

REASONABLE CAUSE PURSUANT TO I.R.C. § 6664

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

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

On December 30, 2003, Treasury and the Service amended the section 6664 regulations to provide that the failure to disclose a reportable transaction, on Form 8886, "Reportable Transaction Disclosure Statement," is a strong indication that the taxpayer did not act in good faith with respect to the portion of an underpayment attributable to a reportable transaction, as defined under section 6011. While this amendment applies to returns filed after December 31, 2003, with respect to transactions entered into on or after January 1, 2003, the logic of this provision applies to reportable transactions occurring prior to that effective date: failure to comply with the disclosure provisions of the law is a strong indication of bad faith.

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

Circumstances that may suggest reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the facts, including the experience, knowledge, sophistication and education of the taxpayer. The taxpayer's mental and physical condition, as well as sophistication with respect to the tax laws, at the time the return was filed, are relevant in deciding whether the taxpayer acted with reasonable cause. See Kees v. Commissioner, T.C. Memo. 1999-41. If the taxpayer is misguided, unsophisticated in tax law, and acts in good faith, a penalty is not warranted. See Collins v. Commissioner, 857 F.2d 1383 (9th Cir. 1988); cf. Spears v. Commissioner, T.C. Memo. 1996-341 (court was unconvinced by the claim of highly

sophisticated, able, and successful investors that they acted reasonably in failing to inquire about their investment and simply relying on offering circulars and accountant, despite warnings in offering materials and explanations by accountant about limitations of accountant's investigation).

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

The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. See Treas. Reg. § 1.6662-4(g)(4)(ii).

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

Although a professional tax advisor's lack of independence is not alone a basis for rejecting a taxpayer's claim of reasonable cause and good faith, the fact that a taxpayer knew or should have known of the advisor's lack of independence is strong evidence that the taxpayer may not have relied in good faith upon the advisor's opinion. Goldman v. Commissioner, 39 F.3d 402 (2nd Cir. 1994). See also Neonatology Associates, P.A. v. Commissioner, 299 F.3d 221 (3rd Cir. 2002)(reliance may be unreasonable when placed upon insiders, promoters, or their offering materials, or when the person relied upon has an inherent conflict of interest that the taxpayer knew or should have known about); Gilmore & Wilson Construction Co. v. Commissioner, 99-1 U.S.T.C. 50,186 (10th Cir. 1999) (taxpayer liable for negligence since reliance on representations of the promoters and offering materials unreasonable); Roberson v. Commissioner, 98-1 U.S.T.C. 50,269 (6th Cir. 1998) (court dismissed taxpayer's purported reliance on advice of tax professional because of professional's status as "promoter with a financial interest" in the investment); Pasternak v. Commissioner, 990 F.2d 893, 903 (6th Cir. 1993)(finding reliance on promoters or their agents unreasonable, as "advice of such persons can hardly be described as that of 'independent professionals'"); Illes v. Commissioner, 982 F.2d 163 (6th Cir. 1992) (taxpayer found negligent; reliance upon

professional with personal stake in venture not reasonable); Rybak v. Commissioner, 91 T.C. 524, 565 (1988) (negligence penalty sustained where taxpayers relied only upon advice of persons who were not independent of promoters).

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

If a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy-related penalty applies to that portion of the understatement unless the reasonable cause and good faith exception applies. The determination of whether a corporation acted with reasonable cause and good faith is based on all pertinent facts and circumstances. Treas. Reg. § 1.6664-4(f)(1).

A corporation's legal justification may be taken into account in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but **only** if there is substantial authority within the meaning of Treas. Reg. § 1.6662-4(d) for the treatment of the item **and** the corporation reasonably believed, when the return was filed, that such treatment was more likely than not the proper treatment. Treas. Reg. § 1.6664-4(f)(2)(i)(B).

The **reasonable belief standard** is met if:

- the corporation analyzed pertinent facts and relevant authorities to conclude in good faith that there would be a greater than 50 percent likelihood ("more likely than not") that the tax treatment of the item would be upheld if challenged by the IRS; **or**

- the corporation reasonably relied in good faith on the opinion of a professional tax advisor who analyzed all the pertinent facts and authorities, and who unambiguously states that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by IRS. (See Treas. Reg. § 1.6664-4(c) for requirements with respect to the opinion of a professional tax advisor upon which the foregoing discussion elaborates).

Other facts and circumstances also may be taken into account regardless of whether the minimum requirements for legal justification are met. See Treas. Reg. § 1.6664-4(f)(4).

Lastly, for purposes of the substantial valuation penalty, the fact that the value of property has been appraised does not ordinarily indicate reasonable cause and good faith. Other factors to consider include: (1) the methodology and assumptions underlying the appraisal; (2) the appraised value; (3) the relationship between appraised value and purchase price; (4) the circumstances under which the appraisal was obtained; and (5) the appraiser's relationship to the taxpayer or to the activity in which the property is used. Treas. Reg. § 1.6664-4(b)(1). When considering an appraisal as an aspect of reasonable cause and good faith in a Notice 2002-21 transaction, particular attention should be paid to factors (3), (4), and (5).