BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**FORMAL OPINION**
JAMES A. ALYN AND LISA E. ALYN	**2009-SBE-001**
	Case No. 258065

Representing the Parties:

For Appellants: James A. Alyn[1]

For Respondent: Ronald J. Babcock, Tax Counsel III

Counsel for the Board of Equalization: Charles D. Daly, Tax Counsel III

This appeal is made pursuant to section 19045[2] of the Revenue and Taxation Code ("R&TC") from the action of the Franchise Tax Board ("FTB") on the protest of James A. and Lisa E. Alyn against a proposed assessment of additional income tax in the amount of $385,884 and the imposition of a penalty for the understatement of tax in the amount of $64,314, for 1997. The issues in this appeal are: (1) whether appellant's obligation in a "short-sale" transaction to return the securities that he had borrowed was a liability for purposes of Internal Revenue Code ("IRC") section 752; (2) whether the "short-sale" transactions into which appellant entered were "sham transactions;" and (3) whether appellant has shown that the accuracy-related penalty imposed by respondent for the understatement of tax attributable to negligence should be abated.[3]

[1] Kenneth M. Barish, Esq., of Kajan, Mather, and Barish, a Professional Corporation, formerly represented appellants and filed the briefing in this matter on their behalf.

[2] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year at issue.

[3] For ease of reference, the term "appellant" will generally refer only to appellant-husband throughout this opinion.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Summary

Appellant entered into "short-sale" transactions in short-term securities that occurred over six days in December of 1997. In effecting the transactions, appellant borrowed securities from his stock broker, sold them, and contributed the proceeds to a partnership that he had recently formed. The partnership assumed appellant's obligation to return securities to the stockbroker in repayment of his obligation. Appellant then contributed his interest in that partnership to a second partnership that he had also recently formed. After the first partnership fulfilled its obligation to return the securities, the second partnership withdrew from the first partnership, received other assets that appellant had contributed to the first partnership, and sold them. The transactions in which the securities were sold, replaced, and returned resulted in a small economic loss. However, the second partnership reported a large loss with respect to the sale of the other assets on its tax return, offset that claimed loss against capital gain from the sale of real property held by another partnership (a substantial interest in which appellant had also contributed to the second partnership), and "passed through" the overall loss to appellant. After auditing appellant and the partnerships, respondent disallowed the claimed loss from the sale of the other assets on the ground that the basis in the other assets had been manipulated to be inappropriately high, assessed additional tax, and imposed an accuracy-related penalty for the underpayment of tax attributable to negligence. Respondent characterized the transactions at issue as a variant of a "Son of Boss" tax shelter, which uses contrived steps with partnerships for the purpose of generating artificial tax losses to offset income from other transactions.

Background

Appellant had been the sole owner of a printed circuit board company, Action Computer Products ("Action"), for thirty-five years before 1997. Action was a subcontractor that sold highly technical military parts to contractors in the defense industry in Southern California and had allegedly been financially successful during most of this period. However, appellant states that Action began losing some of its military and all of its commercial contracts as an indirect result of the Northridge earthquake in 1994 and the attack on the Twin Towers in New York City in 2001, as well as the result of his own mistakes. Action is no longer in business, and appellant is living in another state.

Appellant was also a partner, with an 81.25 percent interest, in Tomal Development

(“Tomal”), a real estate partnership that was formed in 1979. During that year, Tomal purchased 33 acres of land located in Santa Clarita, California, (“the real property”) for future development. Home Depot, an unrelated corporation, made a loan of five million dollars to Tomal in 1993 that was secured by the real property. After Tomal defaulted on the loan, Home Depot began foreclosure proceedings in 1996 and actually foreclosed on the real property on January 10, 1997. The foreclosure resulted in gain taxable to Tomal in the amount of $4,649,227, of which the amount of $3,486,920 would, in the usual course of events, “pass through” Tomal to appellant. It is unclear from the record whether the foreclosure generated any cash, which could have been used to pay the tax liability on the gain, or merely resulted in a “paper” gain. Appellant states that, in addition to having been an entrepreneur, he had owned stocks during his long business career. He also states, in response to questions from our staff, that he has no particular experience in trading treasury notes.

With regard to the real property, appellant consulted two law firms, the Chicago law firm of Altheimer and Gray (“A&G”) and the Los Angeles law firm of Cohen, Primiani & Foster (“CP&F”). CP&F drafted a memorandum (the “CP&F Memorandum”) for its own file, with a copy to appellant, detailing its meeting with appellant and appellant’s attorney, Howard Dicker, on November 18, 1997. That memorandum was obtained as a result of appellant’s release of all of his files to respondent following the issuance of a subpoena obtained by respondent after appellant had filed his appeal. The memorandum specifies that: (1) appellant sought tax planning advice to avoid the $3 million gain as a result of the 1997 foreclosure; (2) he was warned that the plan was a highly risky procedure and that a return utilizing the tax planning would most likely be selected for audit; and (3) the firm gave absolutely no assurances that the contemplated strategy would prevail at audit. In particular, the memorandum provides that:

1. “There have been previous meeting[s] between Howard Dicker, Esq., Jim Alyn, Bradford S. Cohen, Esq. and Duane O. Kamei, Esq. in order to examine potential tax planning matters in order to offset any gains (both ordinary and capital) resulting from a foreclosure during the 1997 taxable year. Apparently Jim Alyn faces a potential gain of approximately $3 million as a result of the 1997 foreclosure and he is investigating certain tax planning opportunities to eliminate that gain.”

2. "The purpose of the meeting in our office on November 18, 1997 was to discuss the pros and cons of the tax planning contemplated and respond to various questions and inquiries raised by both Jim Alyn and Howard Dicker, Esq. (his attorney and advisor). Both Duane and Brad advised Jim Alyn that the tax planning was a highly risky procedure."

3. "During the above-referenced conference with Jim Alyn we had a very detailed discussion with respect to the applicable penalties in the event of an IRS or FTB civil audit…. The penalty structure (as discussed with Jim Alyn in detail) includes a basic penalty for negligence or substantial underpayment of tax in the amount of 20%. This penalty is now codified under the accuracy related penalty code section. However, I also discussed with Jim Alyn the fact that in certain cases the IRS may seek to impose a civil fraud penalty. The civil fraud penalty is much greater and amounts to 75% of the underlying tax due upon which the government seeks to assess as fraud. Under current law I explained that interest accrues on penalties from the due dates of the tax return."[4]

4. "Over all, we explained to Jim Alyn that this office can give absolutely no assurances that in the event of an IRS (or FTB) tax audit with respect to the 1997 taxable year, that he would prevail with respect to the contemplated tax strategy eliminating the approximate $3 million gain as a result of a foreclosure. We repeatedly explained to both Jim Alyn and Howard Dicker, Esq. that this is a very risky tax planning strategy. We explained that this planning strategy will result in a high profile tax return since the return would have to reflect the gull (*sic*) gain of approximately $3 million and then the separate transaction creating losses to offset that gain."

Another document that was received by respondent as a result of the same subpoena was an engagement letter (the "Engagement Letter") from CP&F to appellant that was dated December 22, 1997, but was executed by appellant on May 8, 1998. The Engagement Letter stated that appellant had asked CP&F to complete the organizational documentation for a partnership named "Network Investments." The Engagement Letter also provided that CP&F would "introduce [him] to, and to

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[4] The memorandum also explained that late payment penalties were possible if "he does not utilize the contemplated tax planning strategy but instead files a tax return for and makes a 'self assessment' of approximately $1.4 million of tax due resulting from the foreclosure."

interface with, certain other firms, such as Altheimer & Gray and Transtar Capital Corporation, with respect to certain tax planning strategies promoted by those firms."[5] The Engagement Letter characterized those tax planning strategies as "highly aggressive" and stated that CP&F did not necessarily agree with them. It further stated that "[y]ou have indicated that you are nonetheless willing to proceed with these types of highly aggressive tax strategies based solely on the recommendation and advice offered by them and the continuing advice and assistance offered by us in evaluating the potential benefits and burdens associated with proceeding with any of these strategies."

The Engagement Letter then indicated that appellant would agree that he would "look only to said other firms for advice regarding the efficacy of those tax planning strategies" and that the role of CP&F would be to serve as a liaison with the two other firms and to assist in documenting and implementing those strategies. Finally, the Engagement Letter pointed out that if appellant proceeded with the contemplated tax planning strategies, he might have "to acquire property or other investments (such as a short position in debt obligations or and investment in foreign currencies) which you might not otherwise have acquired in the absence of tax planning. As with any investment, it is possible that these investments will be unprofitable."

In addition to the documents subpoenaed by respondent, our staff also requested additional information from appellant. In reply to the request of our staff for "copies of any written advice from a financial advisor, such as an accountant or broker, explaining the purported economic and/or tax advantages (including the alleged diversification of appellant's portfolio) of trading Treasury Notes on a "short-sale" basis," appellant provided the following documents: (1) a memorandum (the

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[5] The Engagement Letter stated that appellant had already approved the engagement of A&G. In an engagement letter that was dated December 22, 1997, A&G stated that, in return for a fixed fee of $25,000, it would provide "a tax opinion letter and consultation concerning the material tax issues surrounding [appellant's] investment in a U.S. Treasury securities interest rate spread transaction." The letter was signed by Mr. Paul M. Daugerdas, a tax partner at A&G. (See footnote six below for a more complete discussion of Mr. Daugerdas.) In a letter to Mr. Howard Dicker, dated May 14, 2008, (the "Dicker Letter"), CP&F referred to the Engagement Letter of December 22, 1997, as stating that CP&F had worked with A&G and Transtar Capital Corporation in connection with tax planning for appellant. CP&F also expressed its disappointment regarding the delay in receiving a tax opinion from A&G with respect to "the transactions that occurred during December of 1997."

"Memorandum") from Mr. Daugerdas,[6] dated December 5, 1997; (2) an opinion letter (the "Opinion Letter"), dated July 23, 1998, by A&G; and (3) an undated confidential document developed by A&G (the "A&G confidential document") that outlines the kinds of transactions that A&G thought necessary to achieve the tax results desired by appellant.

The Memorandum is entitled "Tax Consequences of Contribution of Assets and Short Sale Obligation to a Partnership or Corporation" and is not addressed to any particular person or entity. It contains extensive legal analysis with regard to "short sales"[7] and a partner's basis in his partnership but does not apply that analysis in a clear way to the transactions into which appellant ultimately entered. The Memorandum concludes, in part, that the basis of a partner's interest in a partnership is not reduced by the amount that has been borrowed in a short-sale transaction.

The Opinion Letter is addressed to appellant and describes generally the transactions under consideration here. It states that it assumes that: (1) the transactions "have been entered into with the intention of earning economic profit;" and (2) the parties to the transactions were not obligated to engage in them upon the completion of any other transaction. Addressing the particular facts of the transactions, the Opinion Letter concludes, in part, that the basis of one of the partnerships that takes part in the transactions is not reduced by the amount that has been borrowed in a short-sale transaction. The legal analysis provided in the Opinion Letter is much less developed than the analysis in the Memorandum but applies that analysis more directly to the particular facts of the transactions at issue here.

The transactions that actually occurred, and are described below, are consistent with the

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[6] As respondent points out, Mr. Daugerdas has been very active in the recent development of the "tax shelter" industry and has been extensively criticized for some of his activities in relation to that industry, particularly those in which he allegedly had a conflict of interest. For example, Mr. Paul Braverman, in an article in the American Lawyer magazine, dated December 5, 2003, criticized Mr. Daugerdas for participating in the development of tax shelters with regard to which he would later write opinion letters favorable to the tax positions taken by the shelters to clients who had engaged him to address the validity of those tax positions.

[7] The concept of a "short-sale" encompasses the obligation of a party who has borrowed fungible property to return the amount of the property that he borrowed on a fixed date in the future. Before he returns that amount of property, the party will typically have sold the property that he had borrowed on the open market and then purchased on the open market the property that he is obligated to return. If the amount of the property that the party sold exceeds the amount of the property that he is obligated to return, the short-sale will have generated a profit. If the amount of the property that he sold is less than the amount of the property that he is obligated to return, the short-sale will have generated a loss.

discussions in the Memorandum, the Opinion Letter, and the A&G confidential document.

The Transactions

On December 1, 1997, appellant formed "Network," a California general partnership in which he owned a 99 percent interest. At that time, he also formed "Advanced," a California general partnership in which appellant also owned a 99 percent interest and an employee of Action (the company of which appellant was the sole shareholder) owned the remaining one percent. On December 24, 1997, appellant borrowed short-term Treasury Notes with a face value of $3,500,000 from his stock broker. On the same day, he sold the Treasury Notes for $3,587,045.32 and apparently purchased U.S Treasury Bills with the proceeds. On December 26, 1997, appellant contributed the amount of $3,649,545 to Advanced. That amount consisted of the foregoing proceeds of $3,587,045, $50,000 in cash, and the value of 625 shares of Superior National Insurance Group ('Superior"). On the same date, Advanced assumed appellant's obligation to return to his stock broker the Treasury Notes that appellant had borrowed from it and purchased 772,043 Japanese Yen for the amount of $5,950. On December 27, 1997, appellant contributed his partnership interests in Tomal and Advanced to Network and remained a 99 percent partner in Network.

On December 30, 1997, Advanced: (1) sold the U.S. Treasury Bills; (2) purchased a Treasury Note for $3,594,232 (with a face value of $3,500,000); and (3) returned the Treasury Note to appellant's stock broker to "cover" the short-sale. The short-sale resulted in an economic loss of $7,187, which is calculated by subtracting the amount needed to purchase the Treasury Note and "cover" the short-sale ($3,594,232) from the amount of the proceeds from the sale of the Treasury Notes ($3,587,045). On the same date, Network withdrew as a partner from Advanced and received from Advanced the Japanese Yen that Advanced had purchased, the Superior stock that appellant had contributed to Advanced, and $44,896 in cash. Later that day, Network sold the Japanese Yen for $5,893 and sold the Superior stock on December 31, 1997, for $8,750.

On its tax return for 1997, Network reported a combined loss of $3,584,404 from the sales of the Japanese Yen and the Superior stock. To calculate the reported losses from each of the sales, Network first allocated the amount of $1,168,315 (after subtracting the cash in the amount of $44,896 that it had received from its claimed basis in Advanced in the amount of $3,643,943) to the basis of the Japanese Yen and the amount of $2,430,732 to the basis of the Superior stock. Network's reporting position was that its claimed basis in Advanced was not reduced by the amount necessary to purchase the Treasury Note to repay appellant's stock broker because that amount was too speculative.[8] Network then calculated its reported loss of $1,162,422 from the sale of the Japanese Yen by subtracting the alleged basis of the Japanese Yen ($1,168,315) from the sales price of $5,893. It calculated its reported loss of $2,421,982 from the sale of the Superior stock by subtracting the alleged basis of the Superior stock ($2,430,732) from the sales price of $8,750.

Network offset the reported combined loss of $3,584,404 against its share of the gain ($3,486,920) from the foreclosure of the real property. It "passed through" the remainder of the combined loss ($103,101) to appellant. Appellant reported that amount of loss on his tax return for 1997. Appellant filed his 1997 return on or about October 15, 1998.

The Audit

After an audit of appellant, Advanced, Network, and Tomal, the FTB determined that the amount that appellant needed to purchase the Treasury Note to repay appellant's broker should reduce the basis of Network's interest in Advanced. Under those circumstances, Network's reported loss in 1997 would be reduced by the amount of $3,594,232, with the result that a gain of $3,457,737 (rather than a loss of $103,101) would have "passed through" to appellant in 1997. Respondent concluded that the amount that appellant needed to purchase the Treasury Note was a liability under IRC 752(b), which

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[8] As discussed in the text below, appellant's legal theory was that his obligation to return the borrowed securities was too contingent or speculative to be considered a liability for purposes of IRC section 752. Under his legal theory, the basis of the partnership interest of a partner in Advanced would never be increased or decreased as a result of that obligation. In contrast, respondent's legal theory, also discussed in the text below, is that appellant's obligation to return the securities was a liability for purposes of IRC section 752. Under respondent's legal theory, the assumption by Advanced of appellant's obligation was treated under IRC section 752(a) as an increase in his share of the liabilities of Advanced and, therefore, as a contribution of money in the amount of that increase by appellant to Advanced. Under IRC section 722, such a contribution of money would increase appellant's basis in Advanced. However, under IRC section 752(b), appellant's individual liabilities were also reduced when Advanced assumed his obligation to return the securities and were treated as a distribution of money from Advanced to appellant. Under IRC section 733, such a distribution of money would decrease appellant's interest in Advanced. At the point of the assumption of the "liability" by Advanced, there is very little difference in the resulting basis of appellant in Advanced under the two legal theories because of the essentially offsetting effect of the application of the two subdivisions of IRC section 752 on appellant's basis. The crucial difference between the two legal theories occurs when Advanced is relieved of the "liability" when it repays appellant's stock broker. Under respondent's legal theory, Network's basis in Advanced (carried over from appellant to Network upon appellant's contribution of his partnership interest in Advanced to Network) is reduced under IRC 752(b) to reflect relief of the liability. Under appellant's legal theory, Network's basis in Advanced is not reduced because Advanced's obligation is not a liability for purposes of IRC section 752(b).

should have been treated as a distribution of cash from Advanced to Network that, in turn, reduced the basis of Network's interest in Advanced by a corresponding amount under section IRC 733. Respondent rejected appellant's position that the amount that appellant needed to purchase the Treasury Note was too speculative to be taken into account for tax purposes in 1997.

As a result, respondent issued a Notice of Proposed Assessment ("NPA") that reduced Network's basis in Advanced by the amount of $3,594,232, disallowed Network's reported combined losses of $3,594,232, disallowed appellant's reported "pass-through" loss of $103,101, and proposed the assessment of underlying income tax on "pass-through" gain from Network of $3,457,737. In addition, respondent imposed an accuracy-related penalty under IRC section 6662(b)(1) for the underpayment of tax attributable to negligence. After respondent denied appellant's protest in a Notice of Action, this timely appeal followed.

<u>Contentions</u>

Appellant contends that he properly deducted the loss with respect to the short-sale of Treasury Notes that he reported on his return for 1997. In support of his contention, appellant relies heavily on what he characterizes as the analogous cases of *La Rue v. Commissioner* (1988) 90 T.C. 465 ("*La Rue*") and *Deputy v. Du Pont* (1940) 308 U.S. 488 ("*Du Pont*"). He argues that those cases support, by analogy, the proposition that the seller's obligation in a short-sale transaction to return the securities that it had borrowed is too contingent or speculative to be considered a liability for purposes of IRC section 752. In *La Rue*, the taxpayer was a partner in a brokerage partnership using the accrual method of accounting that had various large and unanticipated liabilities to its customers and others that were attributable to the failure of the "back office" to keep records that reflected the results of its trades. When the partners sold the business of the partnership to another brokerage firm because of its losses, each partner attempted to add his portion of the "back office" liabilities to the basis of his partnership interest. The Tax Court in *La Rue* held that, under the "all-events" test of Treasury Regulation section ("Treasury Regulation") 1.461-1(a)(2),[9] those liabilities could not be added to the basis of each partner's

[9] Treasury Regulation 1.461-1(a)(2) provides, in pertinent part, that under an accrual method of accounting a liability is incurred for income tax purposes in the taxable year in which all events have occurred that establish the facts of the liability, the amount of the activity can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

interest at that time because the amount of the liabilities could not be determined with reasonable accuracy until missing securities were purchased, or excess securities were sold, at market price. (*La Rue v. Commissioner*, *supra*, 90 T.C. at pp. 478-479.) Appellant analogizes the "back office" liabilities of the partners in *La Rue* to the amount necessary to purchase the Treasury Note to repay appellant's stock broker in the instant matter and argues that the analogy supports his conclusion that such an amount was too uncertain to reduce the basis of Network's interest in Advanced.

In *Du Pont*, the taxpayer borrowed securities of a company in which he held a large financial interest from a brokerage firm and sold them to young executives of the company for the purpose of inducing the executives to remain with the company. Under the terms of his agreement with the brokerage firm, appellant was to return the securities in kind to the brokerage firm within ten years. At the end of the ten years, appellant was compelled to borrow from another brokerage firm the securities that he was required to return to the first brokerage firm. Like his agreement with the first brokerage firm, appellant's agreement with the second brokerage firm required him to return the borrowed securities within ten years, to pay the lender the dividends on the shares of the borrowed stock, and to reimburse the lender for any tax that it accrued with respect to the transaction. On his tax return for the year at issue, the taxpayer claimed a deduction for payments of dividends and reimbursed tax that he made to the second brokerage firm on the alternative grounds that the payments were: (1) ordinary and necessary expenses in carrying on a trade or business during the year under the predecessor statute to IRC section 162; or (2) interest that he paid during the year under the predecessor statute to IRC section 163. The United States Supreme Court ("the Court") disagreed with the taxpayer with regard to both grounds and disallowed the deduction. With respect to the second ground, the Court held that the payments were not "interest" within the meaning of the applicable statute. Appellant contends that *Du Pont* stands for the proposition that the borrowing of stock "for short-sale purposes" does not constitute debt for federal tax purposes and argues that, for that reason, the amount needed to purchase the Treasury note to repay his stock broker was not a liability that would reduce Network's basis in Advanced under IRC sections 752(b) and 733.

Appellant takes the position that he entered into the transactions at issue here for the "business and commercial reason" of diversifying his investments by profiting from an allegedly anticipated swing in short-term interest rates. He emphatically states that he had no reason to form Network and Advanced to aid in the offset of the gain from the sale of the real property because any offset of a loss from the short-sale of the Treasury Notes against the gain from the sale of the real property would have occurred without the existence of Network or Advanced. Appellant also seemingly argues that a reasonable businessman would have concluded that the short-sale of the Treasury Notes would have been profitable even without the existence of any tax benefits. Appellant cites *Compaq Computer Corporation v. Commissioner* ("*Compaq Computer*") (5th Cir. 2001) 277 F.3d 778, rev'g (1999) 113 T.C. 214, for the proposition that transactions which entail little risk as the result of sophisticated financial strategies employing multiple entities, allegedly like the transactions here, should not be treated as shams and should be given effect for tax purposes. He also cites *Compaq Computer* and a footnote in *ACM Partnership v. Commissioner* ("*ACM Partnership*") (3rd Cir. 1998) 157 F.3d 231, 248, footnote 31, for the proposition that a transaction is not invalidated for tax purposes even if a taxpayer enters into the transaction primarily to obtain otherwise unavailable tax benefits.

In *Compaq Computer*, the taxpayer engaged in foreign currency transactions that involved the purchase and resale of American Depository Receipts ("ADRs"). The Tax Court held that the transactions should be disregarded for tax purposes because they lacked "economic substance." (*Compaq Computer Corporation v. Commissioner* (1999) 113 T.C. 214.) Reversing the Tax Court, the Fifth Circuit Court of Appeals ("Fifth Circuit") concluded that the ADR transactions had both "economic substance" and a "business purpose." (*Compaq Computer Corporation v. Commissioner*, *supra*.) The Fifth Circuit noted in *Compaq Computers* that seeking out minimal risk in transactions does not make them a sham and that the entities other than the taxpayer there were both separate from the taxpayer and traded with each other at arm's length. (*Compaq Computer Corporation v. Commissioner*, *supra*, 277 F.3d at pp. 783-784.) The Fifth Circuit also noted, in citing *IES Industries, Inc. v. United States* (8th Cir. 2001) 253 F.3d 350, 355 ("*IES*"), that a taxpayer's subjective intent to avoid tax will not by itself determine whether there was a "business purpose" to a transaction. (*Compaq Computer Corporation v. Commissioner*, *supra*, 277 F.3d at p. 783.)

In *ACM Partnership*, the taxpayer was a partnership created to generate capital losses that could be used to offset earlier capital gains. The Third Circuit Court of Appeals ("Third Circuit") stated in footnote 31 in *ACM Partnership* that transactions which had no "economic substance" and no "business purpose," like those in that matter, were a sham and should be disregarded for tax purposes. The Third Circuit further stated there that it did not intend to suggest "a transaction which has actual, objective effects on a taxpayer's non-tax affairs must be disregarded merely because it was motivated by tax considerations." (*ACM Partnership v. Commissioner*, *supra*, 157 F.3d at p. 248, fn. 31.) Appellant cites a number of other cases to the same effect.

Appellant's final contention is that that even if he is liable for the underlying income tax, the penalty imposed against him for the understatement of tax should be abated allegedly because he reasonably and in good faith followed the advice of his tax advisors, A&G and CP&F, with regard to the tax positions that he took. Appellant's discussion of his alleged reliance on A&G and CP&F is very general and quite limited. The only document that he discusses in this context is the Opinion Letter, which was issued on July 23, 1998. He states that the Opinion Letter "assured [appellant] that the transaction had the requisite merit to pass tax muster." However, appellant suggests that the Opinion Letter was completed to support appellant's tax return, which was filed on or about October 15, 1998. He does not directly discuss whether he relied on an earlier draft of the Opinion letter, or oral advice that was later included in the Opinion Letter, in entering into the transactions at issue.

Appellant relies more heavily on several cases, particularly *Vorsheck v. Commissioner* (9th Cir. 1991) 933 F.2d 757 ("*Vorsheck*"), and *Henry v. Commissioner* (9th Cir. 1999) 170 F.3d 1217 ("*Henry*"), in support of his contention with regard to the penalty. In *Vorsheck*, the Ninth Circuit Court of Appeals ("Ninth Circuit") concluded that the accuracy-related penalty that was imposed under the predecessor statute to IRC section 6662 should be abated because the taxpayers there were unsophisticated about business and tax matters and reasonably and in good faith relied upon the advice of their tax advisor about a tax shelter. (*Vorsheck v. Commissioner*, *supra*, 933 F.2d at pp. 758-759.) In *Henry*, the Ninth Circuit also abated an accuracy-related penalty that was imposed under the predecessor statute to IRC section 6662 on the basis that the taxpayers there reasonably and in good faith relied on the advice of their tax advisor regarding the tax treatment of the sale of options. (*Henry v. Commissioner*, *supra*.) In concluding that the taxpayer acted reasonably in *Henry*, the Ninth Circuit quotes the following language in *United States v. Boyle* (1985) 469 U.S. 241, 251:

> When an accountant or an attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. *See Haywood Lumber*, *supra*, at 771. "Ordinary care and prudence" do not demand such actions.

(*Henry v. Commissioner*, *supra*, 170 F.3d at pp. 1220-1221.)

Respondent contends that it properly disallowed appellant's deduction of the alleged loss with respect to the short-sale of the Treasury Notes. Respondent places its disallowance in the context of pronouncements by the Internal Revenue Service ("IRS") regarding "Son of Boss" tax shelters.[10] Respondent states that the "Son of Boss" tax shelter here is described in Chief Counsel Notice CC-2003-020, which provides, in pertinent part, that the IRS will continue to follow Revenue Ruling 95-26, 1995-1 C.B. 131, with regard to "Son of Boss" transactions in which the obligations of a short-sale are assumed by a partnership. Revenue Ruling 95-26 held that the basis of a partner in a partnership that entered into a short-sale of securities was increased to reflect his share of the partnership's obligation to return the borrowed securities. Respondent also cites Notice 2000-44, 2000-2 C.B. 255, in which other variants of "Son of Boss" tax shelters are described. Notice 2000-44 further states that "Son of Boss" tax shelters are "listed transactions," which respondent characterizes as transactions identified by the IRS as abusive tax schemes that are structured primarily for the purpose of tax evasion.

Respondent makes several arguments in support of its contention. Its first argument is that the obligation on the part of the seller in a short-sale transaction to return the securities that it had borrowed was a liability for purposes of IRC section 752 and, as a result, that liability had to be taken into account in determining the basis of the partner in the partnership that had engaged in the short-sale transaction. Respondent cites Revenue Ruling 95-26 and *Salina Partnership v. Commissioner,* T.C. Memo 2000-352, in support of its argument. It also takes the position that appellant's reliance on *La Rue* and *Du Pont* is misplaced. Respondent distinguishes *La Rue* on the basis that, contrary to *La Rue*,

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[10] A "Son of Boss" transaction is a variation of a somewhat older tax shelter known as "Boss," which is an acronym for "bonds and options sales strategy." (*Jade Trading, L.L.C. v. United States* (Ct. Cl. 2007) 80 Fed. Cl. 11, 57 n. 83 ("*Jade Trading*").)

appellant's liability was known with reasonable certainty on December 30, 1997, because that was the date on which Advanced purchased the Treasury Note with a face value of $3.5 million and returned it to appellant's stock broker. Respondent distinguishes *Du Pont* on the basis that appellant's case was decided under different provisions of the IRC than *Du Pont* and was not concerned with the definition of "interest."

Respondent's main alternative argument is that, regardless of whether the amount of the Treasury Note that Advanced purchased to repay appellant's stock broker was technically a liability for purposes of IRC section 752, appellant's deduction of the alleged loss with regard to the short-sale should be disallowed because it was claimed as a result of "sham transactions." Respondent takes the position that appellant never intended to make a profit, exclusive of tax benefits, on those transactions and that no reasonable businessman would have participated in them. In support of its position, respondent has provided a study of appellant's short-sale transactions by an expert in economics who used interest rate information from the U.S. Treasury Department to evaluate the behavior of $3.58 million in U.S. Treasury Bills over six-day periods taken from 1990 through 1999.[11] In evaluating approximately two thousand combinations developed from this study, the expert concluded that there were only a handful of days in which a profit or loss greater than $100,000, exclusive of transaction costs, would have occurred. The expert further concluded that such evaluated transactions would have generated, on average, a loss of $1,462 and that, when transaction costs were taken into account, all of the evaluated transactions would have generated a substantial loss. The expert states that the transaction costs here included fees of $127,500 for the investment promoter, fees of $50,000 for appellant's tax attorneys, and a payment of $1,682 for the assistance of appellant's stock brokers, for a total amount of $179,182. Respondent cites *Sheldon v. Commissioner* (1990) 94 T.C. 738, 767-768 ("*Sheldon*"), *ACM Partnership*, *supra,* as well as other cases, for the proposition that balancing the profit potential of a

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[11] Respondent's expert was Mr. Bruce F. Deal. Mr. Deal is Managing Principal of Analysis Group, Director of Economic Analysis in the firm's office in Menlo Park, California, and Director of the firm's Insurance Practice. His resume states that "[h]e combines an economics and risk analysis background with many years of experience in economic, litigation, and management consulting…. He has served as an expert witness in various litigation matters, and has been retained as a neutral expert in a complex mediation. His work as an expert has covered a variety of practice areas, including antitrust, finance and securities litigation, damages, and business valuation." Mr. Deal's resume further states that he has completed coursework for a Ph.D. in Public Policy at Harvard University.

transaction (particularly when that potential is minimal) against its tax benefits is appropriate in determining whether the transaction is a sham. Appellant cites *ACM Partnership*, *supra,* and other cases, for essentially the same proposition. Appellant has never disagreed with, or even addressed, the contents of the report of respondent's expert, or provided a report by an expert that he selected.

With regard to the accuracy-related penalty for the underpayment of tax attributable to negligence under IRC section 6662(b)(1) that it imposed against appellant, respondent argues that the penalty should not be abated because appellant has not shown that there was reasonable cause for his understatement of tax and that he acted in good faith with respect to that understatement for purposes of IRC section 6664(c)(1). Respondent rejects appellant's position that he acted reasonably and in good faith by relying on advice from his tax advisors for his tax reporting positions. Of the many reasons that respondent offers in support of its rejection of appellant's position, two reasons are apparently the most significant in its view.

First, respondent states that appellant has not satisfied the requirement of Treasury Regulation 1.6664-4(c)(1)(ii) that, in order to establish that he reasonably relied in good faith on the advice of his tax advisor, the advice must not be based on a representation or assumption that the taxpayer knew, or had reason to know, was unlikely to be true. Respondent points to the language in the Opinion Letter stating that it assumes that the transactions at issue "have been entered into with the intention of earning economic profit" and argues that it is manifest from the evidence in the record in this matter that appellant entered into those transactions only for the purpose of generating a tax loss to offset against the capital gain from the sale of the real property and with the knowledge that any possible economic profit would be minimal.

Second, respondent argues that the very structure of the transactions into which appellant entered shows that he did not act in good faith for purposes of IRC section 6664(c)(1). In particular, respondent argues that appellant formed Network and Advanced, and transferred his partnership interests in Tomal and Advanced into Network, for the purpose of making the underlying transactions less visible to revenue agents and, therefore, less likely to be adjusted. For example, respondent takes the position that appellant formed Network after the foreclosure on the real property so that appellant's relationship to the real property could not be identified without the audit of at least Network and Tomal, and his financial condition, with his associated need for a tax offset on the gain on the foreclosure, examined. In addition, respondent takes the position that appellant improperly "netted" its share of the gain under IRC section 1231 from the foreclosure on the real property against the alleged capital loss from the sale of the Superior stock and against the ordinary loss from the sale of the Japanese Yen. Respondent states that, under IRC section 702(a)(3), Network should have reported, and "passed through," the gain on the foreclosure on the real property as a separately stated item of IRC section 1231 gain. Respondent also states that, under IRC section 702(a)(1), Network should have reported, and "passed through," the alleged loss from the sale of the Superior stock as a separately stated item of capital loss. Finally, respondent contends that, under IRC sections 702(a)(8) and 988(a)(1)(A), Network should have reported, and "passed through" the alleged loss from the sale of the Japanese Yen as a separately stated item of foreign currency loss attributable to an IRC section 988 transaction.

Respondent argues that if Network had separately stated the foregoing transactions, it would have been easier for its auditors to identify the losses on the sales of the Superior stock and the Japanese Yen, respectively, as having been calculated with an inappropriately high basis and to make corresponding adjustments. Respondent relies heavily upon *Long Term Capital Holdings v. United States* (D.Conn. 2004) 330 F.Supp.2d 122 ("*Long Term*") to support its positions. In *Long Term*, the court sustained the imposition of an accuracy-related penalty under IRC section 6662(b), despite the claim of the taxpayer that he had relied in good faith on the advice of his tax advisors, in view of what the court characterized as a transparent attempt by the taxpayer to keep huge alleged tax losses from raising a red flag for an auditor by the use of "netting" devices on his tax return. (*Long Term Capital Holdings v. United States*, *supra*, 330 F.Supp.2d at pp. 211-212.)

With regard to appellant's claim that he relied upon the advice of his tax advisors both reasonably and in good faith when he entered into the transactions at issue here, respondent also alleges that documents received from appellant under subpoena demonstrate that he was aware that it was likely that the transactions would be treated as a sham for tax purposes. For example, respondent points to memoranda and letters to appellant from CP&F cautioning him that the tax planning by A&G with regard to the transactions was extremely risky and stating that CP&F would give absolutely no assurances regarding the planned tax consequences of those transactions if they were challenged by revenue authorities.

Applicable Law

It is well settled that a presumption of correctness attends respondent's determinations as to issues of fact and that appellant has the burden of proving such determinations erroneous. (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Jun. 29, 1980.) This presumption is, however, a rebuttable one and will support a finding only in the absence of sufficient evidence to the contrary. (*Appeal of Oscar D. and Agatha E. Seltzer*, *supra*.) Respondent's determination cannot, however, be successfully rebutted when the taxpayer fails to present uncontradicted, credible, competent, and relevant evidence to the contrary. (*Appeal of Oscar D. and Agatha E. Seltzer*, *supra*.) To overcome the presumed correctness of respondent's findings as to issues of fact, a taxpayer must introduce credible evidence to support his assertions. When the taxpayer fails to support his assertions with such evidence, respondent's determinations must be upheld. (*Appeal of Oscar D. and Agatha E. Seltzer*, *supra*.) A taxpayer's unsupported assertions are not sufficient to satisfy his burden of proof. (*Appeal of James C. and Monablanche A. Walshe*, 75-SBE-073, Oct. 20, 1975.)

R&TC section 17851 incorporates by reference the provisions of the IRC regarding the taxation of partners and partnerships. R&TC Code section 17078 incorporates by reference, unless otherwise provided, IRC section 988.

IRC section 702(a) provides, in pertinent part, that, "[i]n determining his income tax, each partner shall take into account separately his distributive share of the partnership's …(2) gains and losses from sales or exchanges of capital assets held for more than 1 year, (3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions), … and (8) taxable income or loss, exclusive of items requiring separate computations under [certain other provisions of the IRC]."

IRC section 988(a)(1)(A) provides that, except as otherwise provided, any foreign currency gain or loss attributable to a "section 988 transaction" shall be computed separately and treated as ordinary income or loss. IRC section 988(c)(1)(A) provides generally that the term "section 988 transaction" means certain transactions, such as the acquisition of a debt instrument, with respect to which the amount that the taxpayer is entitled to receive, or is required to pay, is denominated in (or determined by reference to) foreign currency.

IRC section 722 provides that "[t]he basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time." IRC section 733 provides, in pertinent part, that, in the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by the amount of any money distributed to such partner.

IRC section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership. IRC section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities attributable to the assumption by the partnership of such liabilities, shall be considered as a distribution of money to the partner by the partnership.

The Court has stated that, in general, a transaction will be respected for tax purposes if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached." (*Frank Lyon Co. v. United States* (1978) 435 U.S. 435 U.S. 561, 583-584 ("*Frank Lyon*").) Federal circuit courts have applied the basic principles stated in *Frank Lyon* and other seminal cases in a variety of ways when developing the "sham transaction" doctrine, particularly in the context of the tax shelter industry. For example, the Third Circuit has indicated in dictum in *ACM Partnership* that a transaction that has actual economic substance, independent of tax considerations, will not be disregarded for tax purposes even if it was motivated by tax considerations. (See *ACM Partnership v. Commissioner*, *supra*.) In contrast, the United States Court of Appeals for the District of Columbia Circuit ("DC Circuit") has cited with approval language from *Zmuda v. Commissioner* (9^{th} Cir. 1984) 731 F.2d 1417, 1421, to the effect that the IRS may deny legal effect to a transaction if its sole purpose is to evade taxation. (*ASA Investerings Partnership v. Commissioner* (U.S. App. D.C. 2000) 201 F.3d 505, 513 ("*ASA Investerings*").) The Fourth Circuit Court of Appeals ("Fourth Circuit") has stated that, to treat a transaction as a sham, a court must find both that the taxpayer was motivated by no purpose other than obtaining tax benefits and that the transaction has no economic substance because no reasonable possibility of a profit existed. (*Rice's Toyota World, Inc. v. Commissioner* (4th Cir. 1985) 752 F.2d 89, 91-92 ("*Rice's Toyota World*").) On the other hand, the United States Court of Appeals for the Federal Circuit ("Federal Circuit") has rejected the position regarding sham transactions taken by the Fourth Circuit in *Rice's Toyota World* and adopted the rule that a lack of economic substance is sufficient to disqualify a transaction for tax purposes without proof that the taxpayer's sole motivation is tax avoidance. (*Coltec Industries, Inc. v. United States* (Fed.Cir. 2006) 454 F.3d 1340, 1355 ("*Coltec II*").[12]) It also left open the possibility that the transaction will be disqualified for tax purposes if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance. (*Coltec Industries, Inc. v. United States*, *supra*.)

The Ninth Circuit has adopted what is sometimes characterized as a "unitary approach" by indicating that it will consider both the prong of a taxpayer's subjective business motivation in entering into a transaction and the prong of the objective economic substance of the transaction in deciding whether a transaction is a sham, but will not apply those prongs in a "rigid two-step analysis" but rather as "precise factors" in determining whether the transaction had any practical economic effects other than the creation of tax losses. (*Casebeer v. Commissioner* (9th Cir. 1990) 909 F.2d 1360, 1363 ("*Casebeer*").) The Ninth Circuit stated in *Casebeer*, with regard to a taxpayer's subjective business motivation in entering into a transaction (what it characterized as the "business purpose test"), that a

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[12] The Federal Circuit in *Coltec II* vacated and remanded the decision of the United States Court of Federal Claims ("Federal Court of Claims") in *Coltec Industries, Inc. v. United States* (2004) 62 Fed. Cl. 716 ("*Coltec I*"). In *Coltec I*, the court invalidated the "economic substance" doctrine (which it characterized, apparently under its reading of *Gregory v. Helvering* (1935) 293 U.S. 465, as a composite of the "business purpose" doctrine, the "substance over form" doctrine, and the "sham transaction" doctrine) on the constitutional ground that the use of the "economic substance" doctrine to trump a taxpayer's compliance with the provisions of the IRC would violate the separation of powers. (*Coltec Industries, Inc. v. United States*, *supra*, 62 Fed. Cl. at pp. 752, 756.) In *Coltec II*, the Federal Circuit concluded, however, that there is no basis for holding the "economic substance" doctrine unconstitutional (noting that even the taxpayer there did not defend on appeal the proposition that the "economic substance" doctrine is unconstitutional) and strongly upheld the use of that doctrine to effectuate the underlying purpose of a provision of the IRC even when there has been literal compliance with the statutory provision. (*Coltec Industries, Inc. v. United States*, *supra*, 454 F.3d at pp. 1351-1355.) Appellant relied heavily on *Coltec I* in his briefing, but the briefing in this matter was concluded before *Coltec II* was issued.

court should determine whether the taxpayer has shown that he had a business purpose for engaging in the transaction other than tax avoidance. (*Casebeer v. Commissioner*, *supra*.) Whether a taxpayer meets the business purpose test is a factual finding. (*Casebeer v. Commissioner*, *supra*.) The Ninth Circuit further stated there, with regard to the economic substance of the transaction (what it characterized as the "economic substance test"), that a court should determine whether the transaction had economic substance beyond the creation of tax benefits or, put another way, whether the transaction from an objective standpoint was likely to produce economic benefits aside from a tax deduction. (*Casebeer v. Commissioner*, *supra*, 909 F.2d at p. 1365.) Whether a taxpayer meets the economic substance test is also a factual finding. (*Casebeer v. Commissioner*, *supra*.)

R&TC section 19164, subdivision (a)(1), provides generally for the incorporation by reference of IRC section 6662. IRC section 6662(a) provides that "[i]f this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies." IRC section 6662(b)(1) provides, in pertinent part, that the foregoing section shall apply to the portion of any underpayment that is attributable to "negligence." IRC section 6662(c) defines "negligence" as any failure to make a reasonable attempt to comply with the provisions of the IRC. Courts have stated that, for purposes of the penalty for underpayment of tax, "negligence is lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances." (*Neely v. Commissioner* (1985) 85 T.C. 934, 947 (quoting *Marcello v. Commissioner* (5th Cir. 1967) 380 F.2d 499, 506).)

R&TC section 19164, subdivision (d), provides generally for the incorporation by reference of IRC section 6664. IRC section 6664(c)(1) provides, in pertinent part, that no penalty shall be imposed under section 6662 with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion. Treasury Regulation 1.6664-4(c)(1) provides generally that all facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) regarding the treatment of the taxpayer (or any entity, plan, or arrangement) under federal tax law. That regulation further states that the taxpayer's education, sophistication, and business experience are relevant in determining whether the taxpayer's reliance on tax advice was reasonable and made in good faith.

Treasury Regulation 1.6664-4(c)(1)(ii) provides that the advice must not be based on unreasonable factual or legal assumptions (including assumptions regarding future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. That regulation further states, as an example, that the advice must not be based on 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 regarding the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.

Respondent's determination of negligence is presumed to be correct, and the taxpayer has the burden of proving the contrary. (*Neely v. Commissioner*, *supra*.) The taxpayer must meet his burden by a preponderance of the evidence. (*Marcello v. Commissioner*, *supra*, 380 F.2d at p. 507).)

Analysis and Conclusion

After the close of briefing in this matter, federal appellate authority directly addressing the issue of whether the obligation to replace treasury notes borrowed to accomplish a short-sale in the "Son of Boss" context is a liability for purposes of IRC section 752 became available for the first time. The Fifth Circuit concluded in *Kornman & Associates, Inc. v. United States* (5th Cir. 2008) 527 F.3d 443, 462 ("*Kornman*"), aff'g *Colm Producer, Inc. v. United States* (2006) 460 F.Supp.2d 713 ("*Colm*"), that the obligation to close a short-sale is a liability for purposes of IRC section 752. In reaching that conclusion, the Fifth Circuit followed Revenue Ruling 95-26 and explicitly distinguished such cases as *La Rue* and other authority upon which the taxpayers there relied.[13] (*Kornman & Associates, Inc. v. United States*, *supra*, 527 F.3d at pp. 458-462.) The Fifth Circuit also concluded, at least under the facts of that matter, that the amount of the liability for purposes of section 752 was the initial proceeds of the

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[13] The Fifth Circuit also cited with approval Revenue Ruling 88-77, 1988-2 C.B. 128. Revenue Ruling 88-77 provides, in part, that the liabilities of a partnership "include an obligation only if and to the extent that incurring the liability creates or increases the basis to the partnership of any of the partnership's assets (including cash attributable to borrowings)." Revenue Ruling 95-26 applied that language to a short-sale by a partnership and concluded that the obligation on the part of the partnership to return borrowed securities was a liability under IRC section 752 because the cash received in the short-sale was an asset of the partnership that increased the basis of the partnership's assets.

short-sale.[14] (*Kornman & Associates, Inc. v. United States*, *supra*, at p. 452.) Judge King, a member of the panel of the Fifth Circuit that heard the appeal from the district court, concurred in both the panel's judgment and the panel's opinion. However, Judge King stated that he wrote separately to emphasize that the underlying transactions in that matter had absolutely no "economic substance" and to express his concern about adopting a rule of law that addresses only a pretence so that the IRS would be spared the expense and delay of litigating fact-bound legal doctrines (like the "sham transaction" doctrine) in a "Son of Boss" matter.[15] (*Kornman & Associates, Inc. v. United States*, *supra*, 527 F.3d at pp. 462-463.)

In a different "Son of Boss" context, the Federal Court of Claims concluded in *Jade Trading*, issued a year earlier than *Kornman*, that "sold options" contributed to a partnership by a partner were merely contingent obligations (in other words, obligations which were not fixed until the options

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[14] In support of its conclusion, the Fifth Circuit cited Revenue Ruling 95-45, 1995-1 C.B. 53. (*Kornman & Associates, Inc. v. United States*, *supra*, 527 F.3d at pp. 459-462.) That ruling states that "the amount of the short-sale liability is the amount of basis to which the short-sale gives rise." It holds that the assumption by a subsidiary of an obligation of its parent to "close out" a short-sale constituted the assumption of a liability for purposes of IRC sections 357 and 358 and that "the amount of the liability assumed is $1000X, the amount of the proceeds of the short sale of the XYZ securities." The ruling does not discuss calculation of gain or loss on the actual "closing out" of the short-sale and does not address what the result would be if the amount necessary to purchase securities to "close out" the short-sale was greater or less than the amount of the proceeds of XYZ securities. Similarly, the Fifth Circuit in *Kornman* was not compelled to consider those exact questions, as the short-sale there was covered by a third-party who had assumed the short-sale liability from one of the partnerships whose transactions the court was examining. (*Kornman & Associates, Inc. v. United States*, *supra*, 527 F.3d at p. 448.) It is noteworthy that, at oral argument, the government in *Kornman* acknowledged that if the short-sale had been covered there before the sale to the third-party, the basis of an interest in that partnership could have been adjusted "to reflect the exact cost of the covering transaction." (*Kornman & Associates, Inc. v. United States*, *supra*, 527 F.3d at p. 460, fn. 17.) In our view, both *Kornman* and Revenue Ruling 94-45 are factually distinguishable from the instant matter and, for that reason, are of limited use in determining the amount of the liability here under IRC section 752.

[15] Deciding the matter on cross-motions for summary judgment, the federal district court granted the government's motion for summary judgment solely on the ground that the obligation to replace the borrowed securities was a liability for purposes of IRC section 752 and did not reach other arguments briefed by the parties there. (*Colm Producer, Inc. v. United States*, *supra*, 460 F.Supp.2d at p. 717.) Among those arguments was an argument by the government that the taxpayers there were not entitled to summary judgment because there were genuine issues of material fact regarding the applicability of the "economic substance" doctrine. (*Kornman & Associates, Inc. v. United States*, *supra*, 527 F.3d at p. 449.) In his concurrence, Judge King appears to be criticizing the government for having brought a motion for summary judgment on a highly technical statutory ground that mooted the issue of whether or not the transactions there had "economic substance," with the result that the issue could not be considered, much less resolved, by the federal district court or the Fifth Circuit.

were exercised) that were not liabilities for purposes of IRC section 752(b).[16] The Federal Court of Claims further concluded, for that reason, that the sold options did not decrease the partner's basis in the partnership under that section. (*Jade Trading, L.L.C. v. United States*, *supra*, 80 Ct. Cl. at pp. 44-45.) Nonetheless, the Federal Court of Claims relied on the reaffirmation of the "economic substance" doctrine in *Coltec II* to determine that the taxpayers there were not entitled to the tax benefits that they claimed, even though they complied with the literal provisions of IRC section 752(b), because the transactions in which they engaged lacked "economic substance." (*Jade Trading, L.L.C. v. United States*, *supra*, 80 Ct. Cl. at pp. 13-14, 45.)

In making its determination, the Federal Court of Claims emphasized that *Coltec II* "teaches that the legitimacy of a transaction for tax purposes is not guaranteed merely because a technical interpretation of the Code would support the tax treatment." (*Jade Trading, L.L.C. v. United States*, *supra*, 80 Ct. Cl. at p. 13.) The Federal Court of Claims also cited with approval language in *Coltec II* describing the "economic substance" doctrine as "a judicial effort to enforce the statutory purpose of the tax code." It then cited language from *Coltec II* which elaborated upon that description: "[f]rom its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit." (*Jade Trading, L.L.C. v. United States*, *supra*, 80 Ct. Cl. at p. 45 (citing *Coltec Industries, Inc. v. United States*, *supra*, 454 F.3d at pp. 1353-1354).)

Of the two cases, *Jade Trading* is more applicable here than *Kornman*. It appears to us that the conclusion reached in *Kornman* that the obligation to return borrowed securities in a short-sale transaction is a liability for purposes of IRC section 752 is correct. However, we question whether *Kornman* provides adequate guidance for determining the amount of the liability for purposes of that section under the facts of this matter. (See footnote 14 above.) In evaluating the applicability of *Kornman*, we note that it is likely that such issues, as well as other aspects of the technical requirements

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[16] In the transaction under consideration there, a number of partners purchased a "euro option" to a company (the "purchased option"), sold another "euro option" to the same company (the "sold option"), and contributed the difference between the amount of the purchase and the amount of the sale (the "option spread") to the partnership. Each partner included in the basis of its partnership interest the amount of the purchased option but ignored the amount of the sold option in computing the basis. (*Jade Trading, L.L.C. v. United States*, *supra*, 80 Fed. Cl. at p. 13.)

of IRC section 752 in this context, will continue to be litigated in federal circuit courts other than the Fifth Circuit. We believe that these issues would benefit from further analysis by other federal circuit courts, particularly the Ninth Circuit (the federal circuit court in which most of the taxpayers whose matters we resolve reside), before we address them further. As a result, we will not resolve this matter on the ground of the technical requirements of IRC section 752(b).

A more important reason, though, for resolving this matter on another ground is that we agree with the courts in *Jade Trading* and *Coltec II* that it is not always appropriate to determine whether taxpayers should receive tax benefits from transactions in which they engage on the basis of whether or not the transactions satisfy the technical requirements of a statute. As we have pointed out, *Jade Trading* held in a "Son of Boss" context that the taxpayers in that matter were not entitled to tax benefits that they claimed, even though they complied with the literal provisions of IRC section 752(b), because the transactions lacked "economic substance." (*Jade Trading, L.L.C. v. United States*, *supra*, 80 Ct. Cl. at pp. 13-14, 45.) The determinations reached by the courts in *Jade Trading* and *Coltec II* regarding the proper treatment of claimed tax benefits after concluding that the transactions underlying them lacked "economic substance" is consistent with the treatment of such tax benefits by the Ninth Circuit and other federal circuit courts under the "sham transaction" doctrine or equivalent doctrines.[17] (See, e.g., *Casebeer v. Commissioner*, *supra*, 909 F.2d at pp. 1362-1368, and other "sham transaction" cases cited above.) Therefore, we will evaluate the alleged "Son of Boss" transactions at issue in this matter under the "sham transaction" doctrine. With regard to the requirements of the "sham transaction" doctrine, we will follow here the approach of the Ninth Circuit in *Casebeer*.

In *Casebeer*, the Ninth Circuit upheld the determination of the Tax Court that a number of transactions under consideration there involving the "sale-and-leaseback" of equipment were shams after considering both the taxpayers' subjective business motivation and the objective economic substance of the transactions. (*Casebeer v. Commissioner*, *supra*.) With regard to the business purpose test, the court concluded that the taxpayers there did not meet that test after taking into account several factors, including their apparent inexperience in equipment leasing, their inadequate investigation into

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[17] As suggested in footnote 12 above and the accompanying text, courts sometimes treat the "sham transaction" doctrine as being a part of the "economic substance" doctrine or, more often, use the terms interchangeably.

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various aspects of the profit potential of the equipment leasing transactions, and the similarly inadequate investigations into those aspects by their professional advisors. (*Casebeer v. Commissioner*, *supra*, 909 F.2d at pp. 1363-1365.)

In applying those factors from *Casebeer*, we note that appellant has acknowledged that he had no particular experience in trading treasury notes and has provided no other reason why he thought that any other professional experience that he may have had would have helped the transactions generate an economic profit. Appellant has also not shown, by providing such evidence as studies by experts in business or economics establishing that the transactions would be economically profitable, that he investigated the economic profitability of the transactions. In like manner, there is no evidence in the record that A&G considered any economic studies regarding the profit potential of the transaction. Therefore, the factors from *Casebeer* are unhelpful to appellant in his attempt to show that he satisfied the business purpose test because they do not show that he had an objective basis for concluding that the transactions at issue would be profitable aside from tax considerations. We also note that although he alleges that he entered into the transactions at issue here for the "business and commercial reason" of diversifying his investments by profiting from a swing in short-term interest rates, appellant has provided no evidence other than his bare allegation to show why he thought that an "investment" in the transactions at issue would have been economically profitable and, as a result, a satisfactory method of diversification. To satisfy the business purpose test of the sham transaction doctrine, the taxpayer must show that he had a business purpose for engaging in the transaction other than tax avoidance. (*Casebeer v. Commissioner*, *supra*, 909 F.2d at p. 1363.) Because appellant has not provided objective evidence that he had a business purpose for engaging in the transactions under consideration other than tax avoidance, we conclude that he has not satisfied the business purpose test.

With regard to the economic substance test, the court in *Casebeer* affirmed the finding of the Tax Court that certain taxpayers there did not meet the economic substance test after comparing each such taxpayer's potential economic return with his investment in the equipment leasing transaction and then determining that, for each such taxpayer, his potential return would not exceed his investment. The court calculated the taxpayer's potential economic return by adding certain interim revenues to the residual value of the equipment and then subtracting the fee that would be paid by the taxpayer to remarket the equipment at the end of its lease. It calculated the taxpayer's investment by adding together the value of the recourse note owed by the taxpayer and the interest on that note. Despite objection by the taxpayer, the court characterized the interest on the recourse debt as a fixed cost of the transaction that should properly be taken into account in calculating the taxpayer's investment in the transaction. (*Casebeer v. Commissioner*, *supra*, 909 F.2d at pp. 1365-1366.)

Here, after evaluating approximately two thousand combinations of possible short-sale transactions developed from his study, respondent's expert concluded that each of those possible transactions would have resulted in a substantial economic loss to appellant when all transactions costs were taken into account. As we have previously pointed out, appellant has not provided any information contradicting the information in the persuasive study by respondent's expert. In addition, his reliance on case law is unavailing to support his position that the transactions had economic substance. Although appellant cites *Compaq* and *ACM Partnership* for the proposition that transactions which entail little risk as a result of sophisticated financial strategies employing multiple entities, allegedly like the transactions here, should not be treated as shams, those cases actually support a somewhat different proposition. More properly, *Compaq* and *ACM Partnership* stand for the proposition that such considerations by themselves do not defeat tax treatment favorable to the taxpayer if the transactions otherwise have an appropriate combination of business purpose and economic substance when the taxpayer enters into them. As that combination is lacking here, appellant's reliance on *Compaq* and *ACM Partnership* is misplaced. Appellant's reliance on those cases to support the proposition that a transaction is not invalidated for tax purposes even if a taxpayer enters into the transaction to obtain otherwise unavailable tax benefits is also misplaced. As suggested above, *Compaq* is better cited for the proposition that a taxpayer's subjective intent to avoid tax will not by itself determine whether there is a business purpose to the transaction. Similarly, *ACM Partnership* stands for no more than the proposition that a transaction that has economic substance is not disregarded for tax purposes merely because it was motivated by tax considerations. As the transactions here had neither business purpose nor economic substance, *Compaq* and *ACM Partnership* are again of no help to appellant. To satisfy the economic substance test, a transaction must, from an objective standpoint, be likely to produce economic benefits aside from a tax deduction. (*Casebeer v. Commissioner*, *supra*, 909 F.2d at p. 1365.) Because the clear weight of the evidence here, viewed from an objective standpoint, shows that the transactions at issue would not produce economic benefits aside from a tax deduction, we conclude that appellant has not satisfied the economic substance test.

Following the approach to sham transactions announced by the Ninth Circuit in *Casebeer*, we conclude that appellant's transactions are, like the transactions there, shams. As a result, we hold that respondent properly disallowed appellant's claimed tax benefits. However, it would make no difference which one of the previously enumerated approaches with regard to the "sham transaction" doctrine was followed in the instant matter. Because the record shows that the transactions at issue here lacked both a business purpose and economic substance, they would have been treated as a sham under any of those approaches and appellant would have properly been denied the tax benefits that he sought.

We also disagree with appellant's contention that the accuracy-related penalty imposed against him for understatement of tax should be abated, even if he is liable for the underlying income tax, allegedly because he reasonably followed in good faith the advice of his tax advisors, A&G and CP&F, with regard to the tax positions that he took. It is clear that appellant did not rely upon advice from CP&F that the tax positions that he took were correct because CP&F explicitly refused to give him such advice. It is also clear that appellant was not relying upon the Opinion Letter, which was dated July 23, 1998, when he entered into the transactions at issue in December 1997. At most, appellant relied upon information that A&G had provided to him at the time when he entered into those transactions, which perhaps was later contained in the Opinion Letter. That sequence of events is consistent with documentation in the record, such as the Memorandum, the Engagement Letter, and the Dicker Letter, which were written in December 1997 before appellant entered into the transactions. That documentation indicates that even though A&G was late in providing to appellant the formal tax opinion regarding those transactions that it had promised to write, both CP&F and appellant were aware of both the transactions and tax advice from A&G regarding those transactions.

There is an obvious discrepancy between the tax advice that A&G gave before appellant entered into the transactions and the refusal by CP&F to give an opinion that such tax advice was correct. In such circumstances, a reasonable and prudent person with business experience would have attempted to resolve the discrepancy in the information that he had received from tax experts by seeking further information about relevant aspects of the transactions with respect to which the tax advice had been given before entering into them. (See *Allison v. United States* (Fed. Cl. 2008) 80 Fed. Cl. 568, 586 ("*Allison*") (citing with approval *Anderson v. Commissioner* (10th Cir. 1995) 62 F.3d 1266, 1272-1273); see also *Freytag v. Commissioner* (5th Cir. 1990) 904 F.2d 1011, 1017.) At least after reviewing the Memorandum,[18] engaging in discussions with A&G and CP&F, and receiving written communications from them, appellant would have understood that a relevant, indeed crucial, aspect of the transactions at issue would have been whether or not they had the potential to generate economic profit apart from tax benefits. Because there is no evidence in the record that appellant sought or received advice from an expert in the economics of the kinds of transactions that he undertook, or made other reasonable economic investigations, we conclude that appellant did not reasonably rely on the advice of A&G in entering into the transactions at issue.[19]

Respondent takes the position that appellant's failure to investigate adequately the profit potential of the transactions at issue also shows that appellant did not rely upon the advice of A&G in "good faith." Appellant's only attempt to show that he did rely on the advice of A&G in "good faith" is his argument that it was unnecessary for him to form Network and Advanced to aid in the offset of the gain from the sale of the real property because any offset of a loss from the short-sale of the Treasury Notes against the gain from the sale of the real property would have occurred without the existence of the two partnerships. However, appellant's argument is disingenuous and only highlights the marked contrast between what should have been reported on appellant's tax return if he had entered into the short-sale transaction in the absence of Network and Advanced and what he reported on his return with regard to the transactions that actually occurred. In concrete terms, if appellant had simply reported on

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[18] The copy of the Memorandum attached as an exhibit to appellant's opening brief contains an extensive discussion of the "sham transaction" doctrine, including the aspect of the doctrine regarding economic substance apart from tax benefits. For reasons that are not explained, the copy of the Memorandum subsequently provided by appellant in response to the request of our staff for additional information (including information regarding the purported economic advantages of trading Treasury Notes on a short-sale basis) omitted that discussion.

[19] We also note that if the Opinion Letter had been issued before the transactions at issue occurred and appellant had relied on it in entering into the transactions, he would not have satisfied the "reasonableness" requirement of Treasury Regulation 1.6664-4(c)(1)(ii) because there is substantial evidence in the record that the transactions would not have been profitable apart from tax benefits and no evidence in the record that they would have been. Appellant would have known, or had reason to know, that his representation in the Opinion Letter that the transactions "have been entered into with the intention of earning economic profit" was unlikely to be true.

his tax return a small economic loss of $7,187 (calculated by subtracting the amount needed to purchase the Treasury Note and "cover" the short-sale ($3,594,232) from the amount of the proceeds from the sale of the Treasury Notes ($3,587,045)) and "offset" that loss against his share ($3,486,920) of the capital gain from the foreclosure on the real property that "passed through" to him from Tomal, the extremely large amount of gain resulting from that "offset" would be dramatically different from the combined loss of $103,101 that appellant reported as having been "passed through" to him by Network. Because we disagree with appellant's argument and he has provided no evidence that he relied on the advice of A&G in "good faith" other than his bare assertion that he did so, we conclude that he has not carried his burden of proof with regard to that issue.

Finally, appellant's reliance on *Henry* and *Vorsheck* is misplaced. With regard to *Henry*, appellant appears to argue that the court there quoted the language from *Boyle* to support the proposition that a taxpayer may rely on the advice of a tax professional under any circumstances. However, we think that *Henry* is best read as concluding that it was reasonable for the taxpayer there to rely upon the advice of his tax advisor because, under the circumstances of that matter, he had no reason not to rely upon him. We note that the court in *Henry*, after first discussing a number of possible reasons why the taxpayer should not have relied upon his tax advisor and then rejecting them, quotes the language from *Boyle* immediately before resolving the matter but does not explicitly apply such language to the facts of that case or discuss it in any systematic way. (*Henry v. Commissioner*, *supra*, at p. 1221.) In contrast, the court in *Allison* extensively discusses *Boyle* and related cases before approving the proposition that if taxpayers are on notice of information that would tend to raise doubts about a contemplated investment, they must reasonably verify or investigate matters themselves even though they had previously consulted a professional advisor. (*Allison v. United States*, *supra*, 80 Fed. Cl. at pp. 583-586.) With regard to *Vorsheck*, that case is factually distinguishable from the instant matter. Unlike the taxpayers in *Vorsheck*, appellant was not an unsophisticated taxpayer blindly following the erroneous advice of tax professionals. Rather, he was an experienced businessman in very difficult financial circumstances who engaged in sham transactions, though adequately warned of the possible consequences, in the hope of obtaining tax benefits to which he was not entitled. In view of the foregoing, we further conclude that appellant has not shown that the accuracy-related penalty imposed against him should be abated.

O R D E R

Pursuant to the views expressed in the opinion, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of James A. and Lisa E. Alyn against a proposed assessment of additional underlying income tax in the amount of $385,884, and the imposition of a penalty for the understatement of tax in the amount of $64,314 for 1997 be and the same is hereby sustained.

Done at Sacramento, California, this 27th day of May, 2009, by the State Board of Equalization, with Board Members Ms. Yee, Ms. Chu, Mr. Leonard, Ms. Steel and Ms. Mandel present.*

Betty T. Yee, Chair

Judy Chu, Ph.D., Member

Bill Leonard, Member

Michelle Steel, Member

________________, Member

*For John Chiang per Government Code section 7.9.