DOCKET NO. 09-72457 and 09-72458

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

HENRY SAMUELI and SUSAN F. SAMUELI, and

THOMAS G. and PATRICIA W. RICKS

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the United States Tax Court

BRIEF FOR PETITIONERS-APPELLANTS

Richard M. Lipton
Baker & McKenzie LLP
130 E. Randolph Drive
Chicago, IL 60601
(312) 861-7590

Robert S. Walton
Baker & McKenzie LLP
130 E. Randolph Drive
Chicago, IL 60601
(312) 861-2540

Attorneys for Petitioners-Appellants

TABLE OF CONTENTS

Page

TABLE OF CONTENTS

(continued)

Page

TABLE OF AUTHORITIES

CASES **Page**

REVENUE RULINGS

STATUTES

REGULATORY AND LEGISLATIVE HISTORY

DOCKET NO. 09-72457 and 09-72458

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

HENRY SAMUELI and SUSAN F. SAMUELI, and

THOMAS G. and PATRICIA W. RICKS

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

ON APPEAL FROM THE DECISION OF
THE UNITED STATES TAX COURT

BRIEF FOR PETITIONERS-APPELLANTS

STATEMENT OF JURISDICTION

On April 27, 2006, the Commissioner of Internal Revenue (the "Commissioner") issued a Notice of Deficiency to Henry and Susan F. Samueli (collectively the "Samuelis") with respect to their federal income taxes for the

taxable years ended December 31, 2001, and December 31, 2003. On April 28, 2006, the Commissioner issued a Notice of Deficiency to Thomas G. and Patricia W. Ricks (collectively the "Rickses" and collectively with the Samuelis the "Taxpayers") with respect to their federal income taxes for the taxable year ended December 31, 2001.

The Samuelis filed a petition in the United States Tax Court (the "Tax Court") on July 19, 2006, in which they sought a redetermination of their tax deficiencies for 2001 and 2003. The Rickses filed a petition in the Tax Court on July 24, 2006, in which they sought a redetermination of their tax deficiency for 2001. On April 2, 2007, the Taxpayers filed a Joint Motion for Consolidation, which was granted by the Tax Court on July 9, 2007. On July 3, 2008, the Taxpayers filed a Motion for Summary Judgment asserting that the securities lending agreement they entered into on or about October 11, 2001, met all the requirements of section 1058.[1] On August 20, 2008, the Commissioner filed a Motion for Partial Summary Judgment asserting that the securities lending

[1] Unless otherwise indicated, all "section" or § references are to the Internal Revenue Code of 1986 (26 U.S.C.) (the "Code"), as amended, or to the Treasury regulations (26 C.F.R.) (Treas. Reg.) issued thereunder, in effect during the years at issue.

agreement failed to meet the requirements of section 1058(b)(3). The Tax Court had jurisdiction to redetermine the correct amount of the deficiency pursuant to sections 6214(a) and 7442.

On May 19, 2009, the Clerk of the Tax Court entered a decision, which is a final, appealable judgment disposing of all claims with respect to all parties. The Tax Court's opinion relating to the issue that is the subject of this appeal is reported at 132 T.C. No. 4 (2009). The Rickses filed a Notice of Appeal from the decision on July 27, 2009. The Samuelis filed a Notice of Appeal from the decision on July 28, 2009. The appeals were timely under sections 7483 and 7502. This Court has jurisdiction to entertain the appeals pursuant to section 7482(a)(1), and venue is proper pursuant to section 7482(b)(1)(A) because the Taxpayers' legal place of residence was California at the time they filed their petitions with the Tax Court.

STATEMENT OF THE ISSUES

The issue on appeal is whether the Tax Court erred in: (1) finding that the securities lending agreement did not meet the requirements of section 1058(b)(3); (2) recharacterizing the securities loan as a purchase and an immediate sale of securities in 2001 followed by a second purchase and an immediate sale of

securities in 2003; and (3) determining the proper tax treatment if the recharacterization is accepted.

STATEMENT OF THE CASE

This case arises from an April 27, 2006, Notice of Deficiency for the Samuelis and an April 28, 2006, Notice of Deficiency for the Rickses (collectively the "Notices of Deficiency") in which the Commissioner determined deficiencies in both of the Taxpayers' income taxes for 2001 and the Samuelis' income tax for 2003. (Excerpts of Record ("ER") 37 & 55.) In 2001, the Taxpayers purchased securities that had a fixed rate of return, loaned the securities to Refco Securities, LLC ("Refco"), a securities broker, and received cash collateral subject to a variable rate fee. Upon termination of the loan in 2003, the Taxpayers were entitled to receive identical securities to those loaned to Refco. However, as permitted in securities lending agreements, Refco cash settled their obligation to return identical securities by paying the Taxpayers the fair market value of the securities on the termination date.

The Commissioner determined federal income tax deficiencies for the Samuelis of $2,177,532 for 2001 and $171,026 for 2003. (ER 37.) The Commissioner determined a federal income tax deficiency for the Rickses of

$6,126 for 2001. (ER 55.) The deficiencies were based on the Commissioner's belief that the securities lending agreement did not meet the requirements of section 1058(b)(3). (ER 44 & 60.) As a result, the Commissioner recharacterized the transaction as a purchase of the securities by the Taxpayers from Refco followed by an immediate sale of the same securities back to Refco in 2001, with no gain or loss realized by the Taxpayers. (ER 44.) Thereafter, when the agreement terminated in 2003, the Commissioner recharacterized the transaction as a second purchase of the securities by the Taxpayers from Refco, pursuant to a forward contract, followed by another immediate sale of the securities back to Refco, with the Taxpayers realizing a short term capital gain of $13,541,604, rather than cash settling the return of the loaned securities (Id.) As a result of this recharacterization, the Commissioner disallowed the interest expense deductions, which arose from the fees for unrestricted use of the cash collateral, claimed by the Samuelis and Rickses in 2001 and the Samuelis 2003. (ER 45 & 60.)

In the alternative, the Commissioner based the 2003 deficiency on the grounds that if the transaction was treated as including a securities loan to which section 1058 applied, section 1258 would cause the capital gain to be treated as ordinary income. (ER 44.)

On July 19 and 24, 2006, respectively, the Samuelis and Rickses timely petitioned the Tax Court and assigned error to the Commissioner's recharacterization of the transaction. (ER 119 & 123.) On April 9, 2007, the Tax Court consolidated the two cases. (Id.) On July 3, 2008, the Taxpayers filed a Motion for Summary Judgment asserting that the transaction met all of the requirements of section 1058 and thus the transaction qualified for nonrecognition as a securities lending agreement. (ER 120 & 124.) On August 21, 2008, the Commissioner filed a Motion for Partial Summary Judgment asserting that the transaction failed to meet the requirements of section 1058(b)(3). (ER 121 & 125.) On March 16, 2009, the Tax Court held in Samueli v. Commissioner, 132 T.C. No. 4 (2009), that the transaction did not meet the requirements of section 1058(b)(3) because the lender did not have the right to require the borrower to return the securities on demand. (ER 8.) As a result, on May 19, 2009, the Tax Court entered the order and final decisions in favor of the Commissioner. (ER 5-7.)

STATEMENT OF THE FACTS

A. Background Information

The Samuelis utilized H&S Ventures, LLC ("H&S Ventures"), a limited liability company treated as a partnership for federal tax purposes, as the primary entity through which they conducted their business affairs. (ER 64, Stip. ¶ 6.) The

Samuelis each individually owned 10% of H&S Ventures, with the remaining 80% owned by The Shiloh Trust ("Shiloh"). (ER 64, Stip. ¶ 7.) Shiloh, as grantor trust for the Samuelis, is a disregarded entity for federal income tax purposes. (ER 64, Stip. ¶ 8.) For purposes of this brief, Shiloh and the Taxpayers will be used interchangeably.

Thomas G. Ricks was the Chief Investment Officer for H&S Ventures and became an investment advisor to the Samuelis in May 2001. (ER 64, Stip. ¶ 9.)

B. Motivation for Investment

Following September 11, 2001, the Taxpayers anticipated that interest rates would decline. Based on this belief, they made a business decision to invest in a transaction that would profit from the declining interest rates. In 2000, the Samuelis had retained Arthur Andersen LLP as their accountant and tax consultant. (ER 65, Stip. ¶ 11.) Prior to 2001, Katherine Szem, the accountant assigned to handle the Samuelis' account, had learned of a transaction described as a leveraged securities transaction. (ER 65, Stip. ¶ 10.) In 2001, Ms. Szem suggested that the Samuelis should consider entering into a leveraged securities transaction. (ER 65, Stip. ¶¶ 11, 12.)

Ms. Szem discussed the pricing and mechanics of the proposed transaction

with Twenty-First Securities Corporation ("Twenty-First Securities"), a brokerage and financial services firm. (ER 66, Stip. ¶ 13.) Twenty-First Securities drafted several memoranda and emails in 2001 providing information to Thomas Ricks regarding the proposed transaction, including hypothetical transactions utilizing fixed income securities and research evidencing the prospect for future interest rate declines. (ER 66-67, Stip. ¶¶ 15-17.) Based on information provided by Twenty-First Securities, Thomas Ricks recommended that the Samuelis invest in the proposed leveraged securities transaction. (ER 67, Stip. ¶ 18.)

C. Structure of Investment

On or about October 11, 2001, the Taxpayers and Refco entered into a Master Securities Loan Agreement (the "Agreement") and an Amendment to the Master Securities Loan Agreement (the "Amendment"). (ER 68, Stip. ¶ 19.) Both the Agreement and the Amendment are on standard forms published by The Bond Market Association. (ER 68, Stip. ¶ 20.) On October 17, 2001, the Taxpayers and Refco entered into an Addendum to the Master Securities Loan Agreement (the "Addendum"). (ER 69, Stip. ¶ 22.)

Like all standard securities lending agreements, the Agreement provided for the return to the Taxpayers of securities identical to the securities that the

Taxpayers initially lent. (ER 89 & 102, ¶¶ 5 & 26.14.) The Agreement also provided that the Taxpayers were entitled to receive all distributions made on or in respect of the loaned securities. (ER 89, ¶ 7.1.)

On October 17, 2001, the Taxpayers purchased a $1.7 billion strip (the "Securities") of the $5.7 billion principal of an unsecured fixed income obligation issued by the Federal Home Loan Mortgage Corporation ("Freddie Mac") with a maturity date of February 15, 2003. (ER 69 & 78, Stip. ¶¶ 23 & 53.) Generally, such a strip is bought at a price lower than its face value, with the face (or "par") value repaid at the time of maturity. The strip does not make periodic interest payments; rather investors profit from the time value of money when they receive the par value of the strip at maturity. Essentially, the difference between the discount price paid and the par value received represents a fixed rate of return on the strip. The Taxpayers purchased the Securities for $1,643,322,000, an amount equivalent to 96.666% of the $1.7 billion par value of the Securities, and thus the fixed rate of return on the Securities was 2.5810%. (ER 69 & 72, Stip. ¶¶ 23 & 36.) The Taxpayers purchased the Securities (1) with a margin loan obtained from Refco pursuant to a Client's Agreement/Margin Agreement and (2) by paying Refco $21,250,000 as a deposit in order to obtain the margin loan. (ER 69-

70, Stip. ¶ 24.)

On October 19, 2001, and pursuant to the Agreement, the Amendment and the Addendum, the Taxpayers transferred the Securities to Refco and obtained the right to receive identical securities at the termination of the transaction. (ER 71, Stip. ¶¶ 29 & 32.) As cash collateral for the Securities, and pursuant to the Agreement, Refco simultaneously provided the Taxpayers with $1,643,322,000, which the Taxpayers used to repay the loan with which they had purchased the Securities. (ER 71, Stip. ¶¶ 29 & 30.) For the use of the $1,643,322,000 cash collateral, Refco charged the Taxpayers a variable rate fee (the "Variable Rate Fee") at a rate of interest (the "LIBOR Variable Rate") that was reset monthly based on the London Interbank Offered Rate (the "LIBOR"). (ER 72, Stip. ¶¶ 33 & 34.) The Taxpayers' deposit of $21,250,000 accrued interest to the Taxpayers' benefit at the same rate as the LIBOR Variable Rate. (ER 72, Stip. ¶ 35.) Collectively, the steps discussed in this section constitute the "Transaction."

Pursuant to paragraph 5 of the Agreement, the Taxpayers could terminate the Transaction by giving notice to Refco prior to the close of business on a "business day," as that term is defined in the Agreement. (ER 74, Stip. ¶ 40.) Pursuant to the Addendum, the Transaction would only terminate on January 15, 2003, or, at the

Taxpayers' option, on July 1, 2002, or December 2, 2002. (ER 74, Stip. ¶ 41.) Additionally, the Addendum gave Refco the right to purchase the Securities if the Taxpayers elected to terminate the Transaction early. (ER 75, Stip. ¶ 42.) The Taxpayers did not exercise their right under the Addendum to terminate the Transaction early. (ER 75, Stip. ¶ 43.)

D. Profit from Investment

As the Variable Rate Fees (i.e., interest) declined, the Transaction became more profitable. (ER 72, Stip. ¶ 37.) If the LIBOR Variable Rate (i.e., interest rate) was less than the 2.5810% fixed rate of return from the Securities, the investment would be profitable. If the LIBOR Variable Rate was greater than 2.5810%, the investment would be unprofitable.

On December 28, 2001, the Taxpayers transferred $7,815,983 to Refco as payment for the accrued Variable Rate Fees. (ER 81-82, Stip. ¶¶ 68-69.) On January 14, 2002, Refco transferred $7,815,983 to the Taxpayers and recorded it as additional cash collateral. (ER 82, Stip. ¶ 70.) The Agreement required Refco to transfer additional cash collateral to the Taxpayers based on the increased fair market value of the Securities. (ER 72-73, Stip. ¶ 38.)

During the term of the investment, the LIBOR declined and the LIBOR

Variable Rate declined correspondingly, from 2.60125% on October 19, 2001, to 1.48% on January 15, 2003 (ER 17.), when the Taxpayers received from Refco $1,697,795,219, the fair market value of the Securities on that date, and paid to Refco $1,684,185,567, comprised of the cash collateral plus the unpaid portion of the Variable Rate Fees (i.e., interest). (ER 83, Stip. ¶ 76-77.) As calculated below, the Taxpayers made a long-term capital gain of $50,916,509 on the transaction and made $40,863,567 in interest payments for a $10,582,270 net profit:

Proceeds of sale of securities from Taxpayers to Refco:	$1,697,795,219
Less: Purchase price of securities:	($1,643,322,000)
Less: Transaction costs:	($ 3,556,710)
Long-Term Capital Gain:	$50,916,509
Less: 2001 and 2003 Variable Rate Fees:[2]	($40,863,567)
Plus: interest on $21.25 million deposit:	$529,331
Net Profit on the Transaction:	$10,582,273[3]

Because the Taxpayers held the Securities for more than twelve months, their net profit on the leveraged securities transaction was long-term capital gain.

E. IRS Recharacterization

The principal issue raised by the Commissioner in the Notices of Deficiency was whether the securities lending agreement at issue complied with the provisions

---

[2] The Taxpayers were obligated to pay Refco $1,684,185,567, consisting of the $1,651,137,983 cash collateral ($1,643,322,000 original cash collateral plus the $7,815,983 additional cash collateral received in 2001) and the $33,047,584 unpaid Variable Rate Fees (the $1,684,185,567 total payment less the 1,651,137,983 cash collateral). Thus, the Taxpayers paid $40,863,567 in total Variable Rate Fees (the $7,815,983 payment in 2003).

[3] This calculation corrects the Tax Court's failure to include the transaction costs and interest earned on the $21.25 million deposit into account. Samueli, 4 T.C. at 12-13.

Tax Courts Determination of Net Profit: ($1,697,795,210 FMV-1,643,322,000 purchase price)	$13,609,652
Less: Transaction Cost:	($ 3,556,710)
Plus: interest on $21.25 million deposit	$529,331
Net Profit:	$10,582,273

of section 1058. (ER 37 & 55.) The Notices of Deficiency stated that since the securities lending agreement did not meet the requirements of section 1058(b)(3), the transaction could not be treated as a securities loan within the scope of section 1058. (ER 44 & 60.) The Commissioner then recharacterized the Transaction as a purchase of the Securities by the Taxpayers from Refco and an immediate sale of those same Securities back to Refco, with no gain or loss realized, rather than a securities loan. (ER 44.) When the Transaction was terminated in January 2003, rather than treating it as the return of the loaned Securities, the Commissioner recharacterized the closing steps as a purchase of securities by the Taxpayers from Refco, subject to a forward contract, followed by an immediate sale of the same securities back to Refco, with the Taxpayers realizing a short term capital gain of $13,541,604. (Id.)

The Commissioner asserted that, alternatively, if the Transaction was treated as including a securities loan to which section 1058 applied, section 1258 would cause the capital gain from the cash settlement of the securities lending agreement to be treated as ordinary income. (Id.)

F. Tax Court Opinion

On March 16, 2009, the Tax Court held in Samueli v. Commissioner that the

Transaction did not fall within section 1058 because the Taxpayers did not have the right to require the borrower to return the Securities on demand. See 132 T.C. No. 4 at 23-24. In making its decision, the Tax Court focused on the meaning of the section 1058(b)(3) phrase "not reduce the…opportunity for gain of the transferor of the securities in the securities transferred." Id. at 16. Analyzing the plain meaning of the phrase, the Tax Court found that the requirements of section 1058(b)(3) would not be met:

> if the Agreement diminished the Samuelis' chance to realize a gain that was present in the Securities during the transaction period. Stated differently, the Samuelis' opportunity for gain as to the Securities was reduced on account of the Agreement if during the transaction period their ability to realize a gain in the Securities was less with the Agreement than it would have been without the Agreement.

Id. The Tax Court concluded that the Addendum reduced the Taxpayers' opportunity for gain in the Securities because it "prevented the Samuelis on all but three days of the approximate 450-day transaction period from causing Refco to transfer the Securities to the Samuelis." Id. at 16-17. The court reasoned that:

> [a]bsent the Agreement, the Samuelis could have sold the Securities and realized any inherent gain whenever they wanted to simply by instructing their broker to execute such a sale. With the Agreement, however, the Samuelis' ability to realize such an inherent gain was

> severely reduced in that the Samuelis could realize such a gain only if the gain continued to be present on one or more of the three stated days.

Id. at 17. Thus, the Tax Court believed that the Taxpayers' opportunity for gain was reduced by the Addendum because it limited their ability to sell the Securities "at any time that the possibility for a profitable sale arose." Id. In so holding, the Tax Court rejected the Taxpayers' position that they retained the opportunity for gain because they continued to own the Securities from the day they were purchased until the day they were sold. Id. According to the Tax Court, "[t]he statute does not speak to retaining the opportunity for gain. It speaks to whether the opportunity for gain was reduced." Id.

The Tax Court also rejected the Taxpayers' argument that section 1058(b)(3) cannot contain a requirement that securities lending agreements be terminable on demand because section 512(a)(5)(B) specifically contains such a requirement. Id. at 19-20. Section 512(a)(5)(A) generally defines the phrase "payments with respect to securities loans" by reference to a transaction to which section 1058 applies. Id. at 20. Section 512(a)(5)(B) ***adds*** that section 512(a)(5)(A) shall apply only where the agreement underlying the transaction "provides for…termination of the loan by the transferor upon notice of not more than 5 business days." Id. The

Tax Court disagreed that the additional requirement contained in section 512(a)(5)(B) would be surplusage if a "terminable on demand" requirement already existed under section 1058. Id. Rather than addressing the surplusage issue, the Tax Court reasoned that the "firmly established law at the time of the enactment of those sections provided that a lender in a securities loan arrangement be able to terminate the loan agreement upon demand and require a prompt return of the securities to the lender." Id. at 21. Without any citation to the "firmly established law," the Tax Court stated that nothing in the statute or legislative history indicated that Congress intended to overrule it. Id.

The Tax Court further stated that the legislative history supported the view that section 1058 codified the common law rule requiring that a securities lending agreement keep the lender in the same economic position that the lender would have been in had the lender not entered into the agreement. Id. at 23. Citing Provost v. United States, 269 U.S. 443 (1926), the Tax Court believed that:

> a lender of securities under a loan agreement retained all of the benefits and burdens of the loaned stock throughout the loan period, as though the lender had retained the stock, and that both parties to the loan agreement could terminate the agreement on demand and thus cause a return of the stock to the lender.

Id. at 24.

The Tax Court concluded that the Transaction was not a securities lending agreement within section 1058 and that the underlying transfers in 2001 and 2003 were therefore taxable events. Id. at 25. The Tax Court then agreed with the Commissioner, without any analysis, that the economic reality of the Transaction as structured was not a securities lending agreement but rather, in substance, two separate sales of securities, the later subject to a forward contract, without any resulting debt obligation running between the Taxpayers and Refco from October 2001 through January 2003. Id. at 25-26.[4]

SUMMARY OF ARGUMENT

The Tax Court erred on multiple items in this case:

First, the Tax Court misinterpreted section 1058(b)(3) by adding a "terminable on demand" requirement not found in the statutory language and directly refuted by section 512(a)(5)(B). Under the Tax Court's analysis, the five-days' notice requirement in section 512(a)(5)(B), which was enacted at the same time as section 1058(b)(3), would be surplusage. Without precedent to guide it, the Tax Court erred in interpreting of section 1058(b)(3), wrongly construing the

[4] Commentators have noted the complications and uncertainty that the Samueli decision will have on the securities lending field. See e.g., "What Were They Thinking? Stock Lending and Samueli," 125 *Tax Notes* 143 (Oct. 5, 2009).

literal language of the Code as well as the legislative history.

Second, the Tax Court treated section 1058(b)(3) as defining a securities lending agreement for tax purposes, whereas this provision merely provides the requirements for nonrecognition of gain when securities are loaned. A securities lending agreement arises whenever one person lends securities to another – that is what happened here. A securities lending agreement is a taxable event to the lender unless section 1058 applies. Therefore, even if section 1058(b)(3) is not satisfied, the Transaction should be treated as a securities lending agreement because the Taxpayers loaned the Securities to Refco and Refco was obligated to return identical securities to the Taxpayers. As a result, the Transaction should be treated for tax purposes as a securities lending agreement, albeit one in which the initial transfer of the Securities by the Taxpayers to Refco would be a taxable event.

Third, although a court has the authority to recharacterize transactions for tax purposes, the court cannot add steps that did not occur or disregard the economic consequences of what did occur. In this case, the Tax Court hypothesized purchases and sales which never occurred and, more importantly, it completely disregarded the economic risks undertaken by the Taxpayers as

securities lenders and by Refco as a securities borrower. Therefore, the Tax Court's recharacterization of the Transaction must be rejected as contrary to economic reality.

Fourth, even if the Transaction is recharacterized in the manner proposed by the Tax Court, the Tax Court has to respect the forward contract which it deemed to exist. Specifically, Tax Court erred by not treating the gain recognized in 2003 as long-term capital gain due to the termination of the deemed forward contract. The Tax Court concluded that gain on the Taxpayers' sale of the Securities in 2003 was short-term capital gain, but this conclusion cannot be reconciled with the fact that the Taxpayers were entitled to this gain due to the forward contract that the Tax Court deemed to have existed since 2001.

The Tax Court's decision should be reversed for any one of these reasons. Collectively, these errors show that the Tax Court's decision cannot be affirmed and, at a minimum, this case needs to be remanded to the Tax Court for reconsideration in light of the proper legal analysis.

ARGUMENT

I. STANDARD OF REVIEW.

The Tax Court's determination as to whether the Taxpayers' securities

lending agreement qualified under section 1058 is a question of law that is reviewed de novo and its factual findings are reviewed for clear error. Charlotte's Office Boutique v. Commissioner, 425 F.3d 1203, 1211 (9th Cir. 2005). The Ninth Circuit reviews de novo a grant of summary judgment. Miller v. Commissioner, 310 F.3d 640, 642 (9th Cir. 2002). The substance of a transaction for purposes of the Code is not a question of fact. See Frank Lyon Co. v. United States, 435 U.S. 561, 581 n. 16 (1978) ("The general characterization of a transaction for tax purpose is a question of law subject to review."); Sacks v. Commissioner, 69 F.3d 982, 986 (9th Cir. 1995) (citing Frank Lyon).

II. THE TRANSACTION MEETS THE REQUIREMENTS FOR A SECURITIES LOAN TO QUALIFY FOR NONRECOGNITION UNDER SECTION 1058.

Section 1058 was added to the Code to provide that gains and losses from a qualified securities lending agreement would be a nonrecognition transaction. A taxpayer who transfers securities that meet the requirements of section 1058 is deemed to hold the securities during the entire period of the transfer. I.R.C. § 1058(c); Gen. Couns. Mem. 36948 (Dec. 10, 1976) ("Generally, in determining the lender's holding period for the securities received in the exchange, its holding period for the securities 'loaned' will be included under Code § 1223(1) since it

takes a substituted basis in the securities received."). Therefore, if the Transaction meets the requirements of section 1058, the Taxpayers would be entitled to long-term capital gains upon the sale of the Securities in 2003 because they had held them for more than twelve months. Section 1058(b) requires that a securities lending agreement shall:

> (1) provide for the return to the transferor of securities identical to the securities transferred;[5]
>
> (2) require that payments shall be made to the transferor of amounts equivalent to all interest, dividends, and other distributions which the owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the transferor and ending with the transfer of identical securities back to the transferor;
>
> (3) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred; and
>
> (4) meet such other requirements as the Secretary may by regulation prescribe.

[5] It is important to note that the securities transferred back to the lender are typically not the same securities that were originally lent by the lender. The original securities are generally sold by the dealer to satisfy obligations to third-parties. The securities transferred back to lender are an identical quantity of securities issued by the particular entity, bearing the same dividend or interest payment rate, but they are merely substantially identical.

A. The Transaction Met the Plain Language Requirements of Section 1058(b).

The Commissioner conceded in his Motion for Partial Summary Judgment, and the Tax Court accepted, that the Transaction satisfied the requirements set forth in sections 1058(b)(1), (b)(2) and (b)(4). Samueli, 132 T.C. No. 4 at 14. Sections 1058(b)(1) and (b)(2) were specifically addressed and met in the Agreement entered into between the Taxpayers and Refco. (ER 89 & 102, ¶¶ 5, 7.1 & 26.14.) Additionally, section 1058(b)(4) is inapplicable because no final regulations have been issued.

In addition, and as is plain from the face of the statute, section 1058(b)(3) contains neither a prohibition against a securities lending agreement having a fixed term nor any requirement that the securities lending agreement be terminable on demand. The statute simply provides that a qualified securities lending agreement "not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred." I.R.C. § 1058(b)(3). The court cannot read a "terminable on demand" requirement into section 1058(b)(3) when the plain language of the statute does not contain such a condition. See e.g., Caminetti v. United States, 242 U.S. 470, 470 (1917) ("When the language of a statute is plain and does not lead to absurd or impracticable results, there is no occasion or excuse

for judicial construction; the language must then be accepted by the courts as the sole evidence of the ultimate legislative intent, and the courts have no function but to apply and enforce the statute accordingly.").

As discussed in further detail below, the Taxpayers retained their opportunity for gain and risk of loss because nothing in the Agreement, the Amendment or the Addendum reduced the benefit to the Taxpayers if the Securities appreciated in value nor limited the Taxpayers' burden if the Securities decreased in value. Upon termination of the Agreement, the Taxpayers would receive back identical securities to those loaned to Refco subject to any and all fluctuations in the market value. Thus, the limited termination dates do not violate the plain meaning of section 1058(b)(3).

B. Proper Statutory Construction of the Five-Days' Notice Requirement in Section 512(a)(5)(B) Precludes Reading a "Terminable on Demand" Requirement into Section 1058(b).

The Tax Court's rejection of the argument that a "terminable on demand" requirement renders portions of section 512(a)(5)(B) as surplusage is erroneous. It is a well-settled rule of statutory interpretation that distinctions in statutes must be given meaning. See Russello v. United States, 464 U.S. 16, 23 (1983) ("[Where] Congress includes particular language in one section of a statute but omits it in

another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion."); Clay v. United States, 537 U.S. 522, 528 (2003) (same); United States v. Napier, 861 F.2d 547, 549 (9th Cir. 1988) (same).

In section 512(a)(5)(B), which was enacted contemporaneously with section 1058, Congress clearly required that securities lending agreements entered into by tax-exempt organizations and regulated investment companies must meet additional safeguards, i.e., the lender must be able to terminate the loan on five-days' notice in order for dividends and interest on the loan to be excluded from characterization as unrelated business taxable income. Specifically, section 512(a)(5)(B) provides that in order for payments made under a securities lending agreement to be exempt from taxation on unrelated business income, the securities lending agreement, ***in addition to*** meeting the requirements of section 1058, must provide for:

> (i) reasonable procedures to implement the obligation of the transferee to furnish to the transferor, for each business day during such period, collateral with a fair market value not less than the fair market value of the security at the close of business on the preceding business day, [and]

(ii) termination of the loan by the transferor **upon notice of not more than 5 business days**. (Emphasis added).[6]

Thus, there are distinctions between the contemporaneously enacted sections 1058 and 512(a)(5)(B) that must be given meaning.

In addition, the Supreme Court has stated that:

> [w]here there are two acts or provisions, one of which is special and particular, and certainly includes the matter in question, and the other general, which, if standing alone, would include the same matter and thus conflict with the special act or provision, the special must be taken as intended to constitute an exception to the general act or provision, especially when such general and special acts or provisions are contemporaneous, as the legislature is not to be presumed to have intended a conflict.

Rodgers v. United States, 185 U.S. 83, 89 (1902); Washington Trust Co. v. Dunaway, 169 F. 37, 46 (9th Cir. 1909) (same). Because section 1058 deals with securities lending agreements in general and section 512(a)(5)(B) provides special safeguards regarding securities lending agreements for tax-exempt organizations and regulated investment companies, section 512(a)(5)(B)'s particular rules applying the five-days' notice requirement should be treated as an exception to

[6] When the statute was enacted, the Securities and Exchange Commission's rules governing regulated investment companies provided a five-days' notice requirement. Priv. Ltr. Rul. 8545001 (June 28, 1985); S. Rep. 95-762 (1978), 1978-2 C.C.

section 1058. If section 1058 generally included a requirement that securities lending agreements must be terminable on demand, as the Tax Court suggests, then the additional safeguards specifically enacted in section 512(a)(5)(B) would be surplusage.

Courts have consistently held that a statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous. See Kawaauhau v. Geiger, 523 U.S. 57, 62 (1998) (Courts "are hesitant to adopt an interpretation of a congressional enactment which renders superfluous another portion of that same law."); Johnson v. Commissioner, 441 F.3d 845, 850 (9th Cir. 2006) (same). To interpret section 512(a)(5)(B), which was meant to provide additional safeguards for tax-exempt organizations, as superfluous language is flawed statutory construction. Thus, section 1058 cannot implicitly include the terminable on demand requirement that the Tax Court reads into the statute. The distinctions in the contemporaneously enacted sections 1058 and 512(a)(5)(B) must be given meaning that does not make the language of either superfluous.

The Internal Revenue Service (the "Service") has acknowledged that section 512(a)(5)(B) was enacted to provide additional safeguards for tax-exempt organizations regarding whether returns from securities lending agreements

constitute unrelated business taxable income. Priv. Ltr. Rul. 8545001.[7] In a private ruling, the Service noted that the safeguards in section 512(a)(5) are founded on securities law and practice. At that time, the Securities and Exchange Commission (the "SEC") provided rules governing the lending of securities by regulated investment companies, which required that the lender be able to terminate the loan within five business days' notice. S. Rep. No. 95-762 (1978), 1978-2 C.C. (the "Senate Report"). The Service believed that the Senate Report clearly indicated the Senate's reliance on the SEC rules in the context of whether "payments on securities loans which satisfy certain requirements are to be treated in the same manner as dividends and interest in the case of a lender which is a [sic] exempt organization or a regulated investment company." Priv. Ltr. Rul. 8545001. The Service never indicated that the SEC rules should apply in the context of general securities lending agreements. However, the Service did note that:

> [i]n making these provisions for payments on securities loans which meet the prescribed standards, the [Senate] committee intends that no inference is to be drawn with respect to the

[7] The Supreme Court has acknowledged that the Service's private rulings serve as authority to the Service's position on an issue. Hanover Bank v. Commissioner, 369 U.S. 672, 686 (1962) (stating that "such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws.").

> active or passive classification of income from securities loans that lack the safeguard required in the bill either for purposes of the unrelated business income tax, treatment as gross investment income, or for other income tax purposes….

Id. Thus, in its private ruling, the Service made clear that tax-exempt organizations should meet the additional safeguards found in the SEC rules governing regulated investment companies in order for dividends and interest on the loan to be definitively excluded from characterization as unrelated business taxable income. But, the Service also made clear that no inference should be drawn if the safeguards (i.e., the five-days' notice requirement) are not met.

C. The Legislative History Does Not Support a "Terminable on Demand" Requirement in Section 1058(b)(3).

The legislative history of section 1058 contains neither a prohibition against a lending agreement having a fixed term nor any requirement that the lending agreement be terminable on demand. In fact, it mirrors the plain language of the statute, stating that a qualified securities lending transaction "not reduce the transferor's risk of loss or opportunity for gain as to the transferred securities." S. Rep. No. 95-762 (1978) at 7.

In 1978, Congress was primarily concerned with addressing the tax consequences of securities loans by two types of lenders: (1) tax-exempt

organizations and regulated investment companies and (2) other securities lenders. Tax-exempt organizations and regulated investment companies were concerned that payments made by the borrowers of securities would be considered unrelated business taxable income, S. Rep. No. 95-762 (1978) at 5-6, whereas, other securities lenders were concerned whether securities loans would be taxable dispositions. S. Rep. No. 95-762 (1978) at 4. The *Summary* section in the legislative history contains a paragraph that begins by stating the general rule that "the lending of securities to a broker and the return of identical securities does not constitute a taxable sale or exchange of the securities and thus does not interrupt the lender's holding period or affect the lenders basis." S. Rep. No. 95-762 (1978) at 1-2. The remainder of the paragraph discusses how tax-exempt organizations and regulated investment companies are treated within this structure, concluding that "with respect to exempt organizations and regulated investment companies, the amendment provides [dividend and interest] treatment only for payments on security loans which are fully collateralized and which may be terminated on 5 business days' notice by the lending organization." S. Rep. No. 95-762 (1978) at 2.

Thus, Congress clearly intended the five-days' notice requirement to apply only to tax-exempt organizations and regulated investment companies. If these

entities are specifically required to be able to obtain the return of the loaned securities within five days, ipso facto other lenders need not satisfy this five-days' notice requirement. Indeed, given that section 512(a)(5)(B) only applies to a transaction that otherwise qualifies as a securities lending agreement, the Tax Court's conclusion that every securities lending agreement must be repayable on demand is completely contrary to Congress' treatment of securities lending agreements to tax-exempt organizations.

The *Explanation of provision* section in the legislative history most clearly distinguishes between securities loans in general and those by tax-exempt organizations and regulated investment companies. In the *In general* subsection, Congress stated that "the committee amendment (in new sec. 1058 of the Code) provides that no gain or loss is recognized by the owner of securities when the owner transfers securities for the contractual obligation of the borrower to return identical securities." S. Rep. No. 95-762 (1978) at 7. Section 1058(b)(3) is consistent with this explanation, providing that the lender is required to retain the risk of loss and opportunity for gain with respect to the loaned securities. However, this explanation does not state that the securities loan must be repayable on demand.

The *Exempt organizations and regulated investment companies* subsection stipulates additional lending requirements. Specifically, in order for payments on securities loans to be treated in the same manner as dividends and interest in the case of tax-exempt organizations and regulated investment companies such that there is not unrelated business taxable income, the agreement between the parties must: (1) be fully collateralized and (2) "permit the lender to terminate the loan at any time upon notice of no more than 5 business days." S. Rep. No. 95-762 (1978) at 8. The additional requirement of termination on five-days' notice would not be required for tax-exempt organizations and regulated investment companies if every securities loan had to be terminable on demand.

Accordingly, the legislative history accompanying the enactment of section 1058 supports the plain language interpretation that section 1058(b)(3) contains neither a prohibition against a lending agreement having a fixed term nor any requirement that the lending agreement be terminable on demand.

D. The Common Law Does Not Support a "Terminable on Demand" Requirement in Section 1058(b)(3).

The limited precedent addressing securities lending agreements prior to the enactment of section 1058 does not support the Tax Court's claim that all securities lending agreements must be terminable on demand. The Tax Court stated that:

> [t]he firmly established law at the time of the enactment of those sections provided that a lender in a securities loan arrangement be able to terminate the loan agreement upon demand and require a prompt return of the securities to the lender.

Samueli, 132 T.C. No. 4 at 21. The Tax Court did not identify the "firmly established law" that supported its claim.

To the extent that the Tax Court was basing its claims about the common law specifically on Provost, it treated the facts in that case as law. The Tax Court specifically discussed Provost, stating that:

> [t]he [Supreme] Court [in Provost] noted that a lender of securities under a loan agreement retained all of the benefits and burdens of the loaned stock throughout the loan period, as though the lender had retained the stock, and that both parties to the loan agreement could terminate the agreement on demand and thus cause a return of the stock to the lender.

Samueli, 132 T.C. No. 4 at 24. However, the language in the Provost case simply describes the transaction that was at issue and does not impose those factual circumstances as a necessary condition for its ruling. Provost involved the imposition of a long-since-revoked stamp tax to a particular securities lending transaction. The Supreme Court, in finding that the tax did not apply, held that legal title of the securities was transferred in a securities lending agreement. The

Supreme Court's opinion does not define a securities loan or otherwise require the treatment accorded by the Tax Court. See Provost, 269 U.S. 443 (1926). Thus, Provost does not stand for the proposition that, for income tax purposes, a securities lending agreement must be terminable on demand.

Likewise, the Service, in Rev. Rul. 57-451, 1957-2 C.B. 295, discussed three situations involving the issue of whether a shareholder has made a disposition of stock. In the second situation, which is relevant here, the stockholder deposited an option stock with a broker in a "safekeeping" account, endorsed the stock certificates, and authorized the broker to "lend" such certificates in the ordinary course of the broker's business to other customers of the broker. The broker had the certificates cancelled and new ones issued in the broker's name. The Service concluded that a disposition had occurred unless the broker satisfied its obligation to replace the certificates by transferring to the optionee certificates representing shares of stock of such kind and amount as to bring the then-completed exchange within the scope of section 1036. In other words, the Service concluded that the transaction, in which securities were loaned, was a taxable disposition unless a nonrecognition provision (in this case, section 1036, which does not contain a "terminable on demand" requirement) applied. However, Rev. Rul 57-451

implicitly recognizes that a transaction can be a securities loan in substance even if it is not eligible for nonrecognition treatment.

Neither Provost nor Rev. Rul. 57-451 purport to define the requirements of a securities loan but, rather, establish whether a disposition has occurred and whether a nonrecognition safe harbor applies in the case of a disposition. The Service is now trying to assert an aggressive reading of these rulings against the Taxpayers, asserting that a transaction has to be recharacterized if it does not meet the requirements of the section 1058 nonrecognition safe harbor. In fact, these authorities support treating the Transaction as a securities loan that is not eligible for nonrecognition of gain.

E. The Taxpayers Did Not Reduce Their "Opportunity for Gain" Under Section 1058(b)(3) Because They Retained the Right to Receive All Positive Fluctuations in Market Value Upon the Return of the Securities.

Assuming the Tax Court's erroneous reading of the plain language of section 1058 and flawed application of basic canons of statutory construction creates ambiguity in the statute, interpreting the term "opportunity for gain" as the Tax Court suggest leads to illogical results. The Tax Court stated that:

> the Samuelis' opportunity for gain as to the Securities was reduced on account of the Agreement if during the

> transaction period their ability to realize a gain in the Securities was less with the Agreement than it would have been without the Agreement.

Samueli, 132 T.C. No. 4 at 16. This definition of the opportunity for gain overreaches. By its terms it would prevent any securities lending agreement not instantly terminable from qualifying under section 1058(b)(3). This is because whenever a taxpayer enters into **any** securities lending agreement, the agreement transfers title and possession of the securities for some time and the taxpayer's ability to sell the securities is less with the agreement than it would have been without the agreement. Based on the Tax Court's standard for measuring the opportunity for gain, even a securities loan agreement for a single day would be disqualified under section 1058(b)(3) because the lender would be unable to immediately benefit from a brief positive fluctuation in the market value of the securities on that day. Even a demand loan might not qualify under the Tax Court's standard, as there would inevitably be some delay before the securities could be transferred back to the lender. Simply put, the Tax Court's position would disqualify every securities lending agreement under section 1058 that transfers possession of the securities, which is the essence of a securities loan, as it will always reduce the lender's opportunity for immediate gain.

In fact and in law, the Taxpayers retained their opportunity for gain because they retained the benefit (or detriment) of any fluctuation in the market value of the Securities throughout the term of the securities lending agreement. The Taxpayers benefited from any increase in the value of the securities during the term of the Agreement. If one "retains" the opportunity for gain, one has not "reduced" the opportunity for gain.

The Service's previous interpretation supports the Taxpayers' reading of the term "opportunity for gain." The Service stated that "for gain or loss on the transfer of securities pursuant to a securities lending agreement to be excluded from gross income, the agreement must not protect taxpayer from ***fluctuations in the market value*** of the securities taxpayer lends to borrowers." Field Service Advisory 1997 WL 33313772 (Sept. 2, 1997) (emphasis added). The Service concluded that:

> the securities lending agreement here does not protect taxpayer from fluctuations in the market value of the securities lent to borrowers. For example, section 13.9 of the agreement, which concerns the termination of a loan, requires a borrower to return securities identical to the borrowed securities. This provision does not speak in terms of returning to the lender securities with a market value equal to the market value of the securities on the day such securities were lent to the borrower.…[T]he fact

> that the taxpayer receives credit only for the market value of the securities on the date the securities should have been returned indicates that the taxpayer is not protected from the risk of loss or opportunity for gain with respect to the borrowed securities….
>
> Similarly, section 13.10 of the agreement provides that in the event the trust company as lending agent is unable to return the borrowed securities to the taxpayer or purchase for the taxpayer such securities on the open market, the lending agent must credit the taxpayer's account with the market value of such securities determined as of the date such securities should have been returned. Again, the fact that the taxpayer receives credit only for the market value of the securities on the date the securities should have been returned indicates that the taxpayer is not protected from the risk of loss or opportunity for gain with respect to the borrowed securities.

Id. The implication of the Service's interpretation is that the opportunity for gain or risk of loss is fully preserved as long as, ultimately, the identical quantity of originally loaned securities is returned to the original lending party under the agreement. The Service specifically concluded "that section 1058(b)(3) concerns the risks and opportunities that result from a lender's exposure to market fluctuations. Accordingly, if taxpayer remains subject to the risk of market fluctuations with respect to the securities lent to borrowers, we conclude that the agreement does not run afoul of section 1058(b)(3)." Id.

Under the Agreement, upon the termination of the loan, Refco was obligated to return to the Taxpayers an identical quantity of the Securities. Based on the Service's own prior interpretation, and contrary to the Tax Court's assertions, the Taxpayers did not reduce their opportunity for gain because they remained subject to all fluctuations in the market value of the Securities upon their return.

III. THE TRANSACTION QUALIFIES AS A SECURITIES LENDING AGREEMENT EVEN IF IT DOES NOT QUALIFY FOR NON-RECOGNITION UNDER SECTION 1058.

A. The Transaction Was Factually a Securities Lending Agreement.

In a securities lending agreement, the owner of a security "lends" the security to a counterparty in exchange for the counterparty's contractual commitment to return identical securities to the lender and to make substitute or "in-lieu-of" payments equal to any dividends, interest or other distributions the security lender would have received had he continued to hold the securities. Thus, the securities lender retains complete economic exposure to the loaned securities, but that exposure is evidenced by a contractual right rather than the possession of the underlying securities. In such circumstances, the authorities have consistently held that the securities lender is not the "legal" owner even though the benefits and burdens of ownership are retained. See Provost, 269 U.S. at 443 (stating that "both the loan of stock and the return of borrowed stock involve 'transfers of legal title to

shares of stock'…", but also that "[d]uring the continuance of the loan the borrowing broker is found by the loan contract to give the lender all the benefits and the lender is bound to assume all the burdens incident to ownership of the stock which is the subject of the transaction, as though the lender had retained the stock.").[8]

The Transaction was factually a securities lending agreement as set forth in the Agreement, the Amendment and the Addendum. On October 17, 2001, the Taxpayers purchased the Securities with a $1,643,322,000 margin loan from Refco and by making a $21,250,000 equity investment. (ER 69-70, Stip. ¶¶ 23 & 24.) The trade ticket whereby the Taxpayers purchased the Securities contains the following notation:

[8] Subsequent rulings have misconstrued the narrowness of the Provost opinion, interpreting it to hold that tax ownership is transferred as well. See e.g., Rev. Rul. 60-177, 1961-1 C.B. 9 (in which the purchaser rather than the lender in a short sale transaction was the real owner of the stock and was entitled to the dividends-received credit and the partial exclusion with respect to the cash dividends received on such stock); Rev. Rul. 80-135, 1980-1 C.B. 18 (in which the lender, who entered into a securities lending agreement, was no longer the owner of a municipal bond and was not entitled to an interest exclusion on in-lieu-of interest payments because title passed to the purchaser as a result of the short sale).

> REFCO SELLS TO SHILO [sic]. INITIAL LOAN TO 11/05/01 AT 2.60125% (10BP TO XXI), RESETS AT LIBOR PLUS 10BP (10BP TO XXI). NO MIN MAX, LOAN TERMINATES 1/15/03. 1.25% MARGIN.

(ER 70, Stip. ¶ 28.) Following their purchase of the Securities and pursuant to the Agreement, on October 19, 2001, the Taxpayers loaned the Securities to Refco (ER 71, Stip. ¶ 29), which used the Securities to make timely deliveries of securities to cover a short sale to a customer and to finance securities that Refco had already purchased in order to make a sale to a customer.

Under the loan, the Taxpayers were *entitled to receive of all distributions* made on or in respect of the loaned Securities and they obtained the *right to receive identical securities* at the termination of the transaction. (ER 89 & 102, ¶¶ 5, 7.1 & 26.14.) No provisions in the Agreement, the Amendment or the Addendum modified the right to receive identical securities at the termination of the loan, subject to any fluctuations in market value that occurred between October 19, 2001, and January 15, 2003, the date of the termination. Thus, the Taxpayers retained complete economic exposure to the loaned securities, but that exposure was evidenced by a contractual right (i.e., through the Agreement, the Amendment and the Addendum) rather than the possession of the underlying Securities. Loans of securities are common in the financial markets and it is common in the financial

industry for the broker to hold the Securities as security for margin loans.

B. The Transaction Had Economic Substance.

Contrary to the Tax Court's position, and as presented in the stipulated facts, the objective economic substance of the Transaction reflected a securities lending agreement. Prior to the securities lending agreement, the Taxpayers and Refco held the following positions:

	Taxpayers	**Refco**
1)	Held at least $21,250,000 in their accounts.	Held no funds or accounts belonging to the Taxpayers.
2)	Had no obligations to Refco.	Had no obligations to the Taxpayers.
3)	Had no relation to Refco.	Had no relation to the Taxpayers.

After October 19, 2001, the Taxpayers and Refco held these positions:

	Taxpayers	**Refco**
	Transferred $21,250,000 to Refco. (ER 69-70, Stip. ¶ 24.)	**Received $21,250,000 from the Taxpayers. (ER 69-70, Stip. ¶ 24.)**
1)	Had the right to receive interest on the $21,250,000 paid to Refco. (ER 72, Stip. ¶ 35.)	Obligated to pay interest on the $21,250,000 loaned by the Taxpayers. (ER 72, Stip. ¶ 35.)
2)	Obligated to repay the $1,643,322,000 cash collateral plus Variable Rate Fee to Refco. (ER 72, Stip. ¶ 33.)	Had the right to receive repayment of $1,643,322,000 cash collateral plus Variable Rate Fee from the Taxpayers. (ER 72, Stip. ¶ 33.)
3)	Had the right to receive identical securities from Refco at the termination of the transaction. (ER 71, Stip. ¶ 32.)	Obligated to return identical securities to the Taxpayers at the termination of the transaction. (ER 71, Stip. ¶ 32.)

The Transaction was a highly leveraged securities lending agreement undertaken to benefit from declining interest rates. The Taxpayers were entitled to and did receive a 2.5810% fixed rate of return on the Securities. (ER 71-72, Stip. ¶¶ 29 & 36.) The Taxpayers were obligated to and did repay the $1,643,322,000 cash collateral plus the accrued Variable Rate Fee. (ER 87 & 89, ¶¶ 3.2 & 5 and ER 72, Stip. ¶ 33.) Whether the Taxpayers made or lost money depended on the Variable Rate Fee (i.e., interest) they had to pay Refco for the use of the cash collateral. (ER 72, Stip. ¶ 37.) If the LIBOR Variable Rate was less than the

2.5810% fixed rate of return on the Securities, the investment would be profitable; if the LIBOR Variable Rate was greater than 2.5810%, the investment would be unprofitable. Because LIBOR declined during the term of the investment, the Taxpayers made a net profit of $10,582,273 from the Transaction. Had LIBOR remained the same or increased, the transaction would have been unprofitable. Thus, the objective economic realities, in accordance with the stipulated facts, reflect that the Taxpayers entered into a securities lending agreement with significant risks.

The investment decision to enter the Transaction described above was based on a valid business purpose, i.e., to take advantage of the Taxpayers' belief that interest rates would drop after September 11, 2001. It is well established that the economic substance test is satisfied if the Taxpayers can demonstrate either that they had a subjective profits motive (i.e., a valid business purpose) or that they had a reasonable opportunity to earn a pre-tax profit. Frank Lyon Co., 435 U.S. at 581-584. Given that the Taxpayers had a valid business purpose to enter the Transaction, they had the right to structure the Transaction in a way that would minimize their tax liability. See Gregory v. Helvering, 293 U.S. 465, 469 (1935) ("The legal right of a taxpayer to decrease the amount of what otherwise would be

his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."); Bass v. Commissioner, 50 T.C. 595, 600 (1968) ("[A] taxpayer may adopt any form he desires for the conduct of his business, and...the chosen form cannot be ignored merely because it results in a tax saving.").

C. The Transaction Should be Taxed as a Securities Lending Transaction Even if it Does Not Qualify for Nonrecognition Under Section 1058.

Because the Transaction was, in fact, a securities lending agreement that had economic substance, the form of the Transaction must be respected. The Transaction must be treated as a securities loan (which is what it was) whether or not section 1058 applies. Section 1058 specifies whether a securities loan will qualify for nonrecognition of gain, but it is not a definitional provision which sets forth the exclusive boundaries as to what constitutes a "securities loan" for tax purposes. A securities loan that does not satisfy section 1058 is still a securities loan, but the transfer of the securities by the lender is treated as a taxable disposition.

While there is a dearth of case law regarding section 1058, it has been described as a safe harbor on multiple occasions. The American Bar Association has described section 1058 as "a safe harbor from the recognition of gain or loss

where a taxpayer exchanges securities pursuant to an agreement that meets the statutory requirements" of section 1058. *ABA Committee Reports on Securities Lending Transactions*, 91 TNT 107-33, Section IV.1.B (1991). In addition, the Service stated in a Technical Memorandum that "the taxpayer does not qualify for nonrecognition under the narrow I.R.C. § 1058 statutory *safe harbor* provisions applicable to certain security lending transactions." IRS Coordinated Issues Papers "Variable Prepaid Forward Contracts Incorporating Share Lending Arrangements," (Feb. 6, 2008) (emphasis added). Even if section 1058 is the sole route to nonrecognition rather than a safe harbor, as some commentators believe based on the proposed regulations under section 1058, the Transaction should nonetheless be a taxable securities lending agreement based on its form and economic substance.

Assuming the Taxpayers do not meet any nonrecognition provision, their purchase and deemed sale of the Securities in 2001 would be taxable, but they would recognize no gain because the purchase and sales prices were equal. As noted by Congress, the Service in Rev. Rul. 57-451 concluded that "a securities lending transaction involves the substitution of the broker's contractual obligation for the lender's stock." S. Rep. No. 95-762 (1978) at pp. 5-6. Thus, in October 2001, the Taxpayers would have received from Refco a contractual right to obtain

identical securities (the "Contractual Right") in exchange for the Securities. The Taxpayers would have a basis in the Contractual Right equal to the value of the Securities transferred (i.e., $1,643,322,000). In addition, as is common practice in securities lending agreements, the Taxpayers received cash collateral for loaning the Securities.

The Contractual Right was property held by the Taxpayer that was taxable as a capital asset under section 1221, which defines capital assets, because none of the exceptions thereunder were applicable to the Transaction. In addition, Section 1234A(1), in relevant part, provides that gain or loss attributable to the cancellation or termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset. The Contractual Right was and the Securities would be, if held by the Taxpayers, a capital asset. Therefore, the gain from Refco's termination of the Taxpayers' Contractual Right to receive identical securities (and Refco's obligation to return identical securities) by paying the Taxpayers the fair market value of the Securities should be capital gain. Because the Taxpayers held the Contractual Right for more than twelve months, the termination of the Contractual Right in exchange for the fair market value of the

Securities resulted in long-term capital gain of $50,916,509.

Moreover, the Variable Rate Fee should be treated as an interest payment deductible to the Taxpayers. Under the Agreement, Refco was required to provide the Taxpayers with cash collateral for the loan of the Securities. According to the Supreme Court, "interest" and "indebtedness" have well-known meanings and, "[i]n the business world, 'interest on indebtedness' means compensation for the use or *forbearance* of money." Deputy v. Dupont, 308 U.S. 488, 498 (1940) (emphasis added). See also Fontana Power Co. v. Commissioner, 127 F.2d 193, 194 (9th Cir. 1942) (same); Commissioner v. Raphael, 133 F.2d 442, 445 (9th Cir. 1943). The courts have interpreted "indebtedness" to require an existing, unconditional, enforceable obligation to pay a principal sum. Williams v. Commissioner, 47 T.C. 689, 692 (1967). During the loan period, the Taxpayers paid a fee for the unrestricted use of the cash collateral (i.e., Refco forbore the use of the funds). In addition, the Taxpayers were required to repay the cash collateral (i.e., a principal sum) to Refco upon the termination of the loan. Thus, the Variable Rate Fee was interest on indebtedness.

If the Transaction is viewed as a securities loan that is not eligible for nonrecognition of gain, then the Taxpayers' treatment of the Transaction on their

tax returns was correct. This conclusion is the opposite of the Tax Court's determination that, as discussed in further detail below, was based on an erroneous analysis of the Transaction in the event that section 1058 did not apply.

IV. THE ECONOMIC SUBSTANCE OF THE TRANSACTION DOES NOT SUPPORT THE TAX COURT'S RECHARACTERIZATION OF THE TRANSACTION.

A. The Tax Court's Recharacterization is Not Supported by the Stipulated Facts of the Transaction.

Whether section 1058 applied to the Transaction has no bearing on the existence of a collateralized securities loan and the rights and legal obligations under the Agreement, the Amendment and the Addendum. According to the Tax Court, the Transaction did not qualify as a securities loan solely because "the cash transferred in 2001 [the cash collateral on the securities loan] represented the proceeds of the first sale and not collateral for a securities loan." Samueli, 132 T.C. No. 4 at 27. However, the Tax Court does not explain why the cash collateral should be recharacterized as sale proceeds or why the Transaction as a whole should be recharacterized as two separate purchases and immediate sales in 2001 and 2003. The Tax Court merely stated that:

> For Federal-tax purposes, the characterization of a transaction depends on economic reality and not just on the form employed by the parties to the transaction. See

> Frank Lyon Co. v. United States, 435 U.S. 561, 572-573 (1978). We agree with respondent that the economic reality of the Transaction establishes that the Transaction was not a securities lending arrangement as structured but was in substance two separate sales of the Securities without any resulting debt obligation running between petitioners and Refco from October 2001 through January 15, 2003.

Samueli, 132 T.C. No. 4 at 25. The Tax Court gives no explanation as to why its recharacterization is more appropriate than following the form and economic substance of the Transaction as described above.

The Tax Court attempted to solve the nature of the Taxpayers' obligation to return the cash collateral plus interest to Refco by calling it the purchase price to be paid on a "forward contract" created by the terms of the Addendum. The Tax Court assumed their characterization left no debt on which interest could be payable, citing to the Goodstein v. Commissioner, 30 T.C. 1178 (1958), line of cases. Goodstein did not involve a securities lending agreement but did involve a margin loan and purported interest obligation, which the court found as a fact not to be an indebtedness and interest at all. If the Tax Court is to rely on Goodstein it must address the factual issue Goodstein addressed: was there an indebtedness as normally determined?

The Tax Court said that in the Transaction, as in Goodstein, the supposed

securities lender and the broker purported "...to create debt through initial steps that completely offset each other. Courts consistently disregarded those offsetting steps because they left the parties to the transactions in the same position they were in before the steps were taken." Samueli, 132 T.C. No. 4 at n. 13. In other words, the Tax Court assumed without much analysis that a combination of a highly leveraged margin loan and a lending of the purchased stock to the margin lender for cash collateral can never be treated as a securities loan creating a payment obligation. This conclusion cannot be justified by a cite to Goodstein, because the court in Goodstein found as a fact that the parties never intended that an obligation to pay money be created. There are no grounds for such a fact finding in the Transaction and it was not found by the Tax Court.

As previously discussed, the Taxpayers and Refco did not engage in offsetting steps in October 2001, which left them in their original positions, and they intended to create certain payment obligations and rights. Based on the stipulated facts:

- The Taxpayers were ***obligated to return*** the cash collateral ***plus interest*** to Refco (ER 87 & 89, ¶ 3.2 & 5 and ER 72, Stip. ¶ 33.);
- The Taxpayers were ***entitled to receive*** all distributions made or in respect of the Securities (ER 89, Stip. ¶ 7.1.); and
- Refco was ***obligated to return*** identical securities to the Taxpayers at

> the conclusion of the Transaction. (ER 71, ¶ 32.)

As a result, the Taxpayers were bound by an indebtedness and the resulting interest payment obligations, which would not have existed if the Securities had been sold. Likewise, the right to receive all the distributions made or in respect of the Securities would not have existed if the Securities had been sold in 2001.

Moreover, Frank Lyon also stands for the proposition that genuine transactions, undertaken between unrelated parties that vary control or change the flow of economic benefits must be respected for tax purposes. The Supreme Court in Frank Lyon stated:

> In short, we hold that where, as here, there is a genuine multiple-party transaction with 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, the Government should honor the allocation of rights and duties effectuated by the parties.

435 U.S. at 583-84. The Taxpayers and Refco were unrelated parties who entered into a transaction at arm's-length. The inability of the Taxpayers to retrieve the Securities on demand suggests that the Transaction was made at arm's-length. If the Transaction had been collusive, the parties would have papered it in a way that mimicked as closely as possible section 1058 and the proposed regulations

thereunder. If Refco had been the Taxpayers' agent, the documents could have been terminable on demand, with the parties' understanding that the Transaction would run until just before the securities matured. But presumably, the arm's-length negotiations led to the Taxpayers giving up that right. Thus, the Transaction should be taxed following the form and economic substance as described above.

B. The Tax Court's Recharacterization Erroneously Changes the Risk involved in the Transaction.

The fundamental flaw of the Tax Court's recharacterization of the Transaction is the failure to consider that the economic consequences to the parties from the recharacterized transaction were different than the economic consequences of the transaction that the parties actually entered into. Specifically, the Tax Court failed to consider the counterparty risk that existed in the Transaction. This risk shows why the Transaction has to be treated as a securities loan and not as simply two separate sale transactions.

Counterparty risk arises in every financial transaction in which a party to the transaction is exposed to risk of loss due to nonperformance by the other party to the transaction. Recharacterization of a transaction should not affect either parties' exposure to risk, because the recharacterization cannot alter (and, indeed, must conform to) the economic substance of the original transaction. Field Service

Advisory 199935019 (June 1, 1999) ("Any recharacterization of the transactions under the substance over form doctrine should leave the parties in the same ultimate economic positions."). The Tax Court characterized the Transaction as two separate sales, one of which was completed in 2001 and the second of which was completed in 2003. Separate sales would have minimized counterparty risk, because the two transactions would not be financially interdependent. For instance, if Refco filed for bankruptcy after the deemed 2001 purchase, the Taxpayers would have no obligation to return the cash collateral and would be subject to little risk. Likewise, if the Taxpayers filed for bankruptcy after the deemed 2001 sale, Refco would have no obligation to return the Securities.

In the transaction that actually occurred, however, there were three layers of counterparty risk. First, because the Taxpayers loaned securities to Refco, the Taxpayers were exposed to risk in the event that Refco was unable to repay the loan by returning the borrowed securities. If Refco filed for bankruptcy and the securities were not returned, the Taxpayers would have been obligated to return the cash collateral and reduced to the status of a creditor in the bankruptcy case, which

could have resulted in a substantial loss.[9]

Second, Refco was taking counterparty risk. If the Taxpayers filed for bankruptcy, they would not be able to return the collateral that was posted in exchange for the securities loan. Refco would have been required to return the borrowed securities but would have been at risk with respect to its collateral.

Third, Freddie Mac could have entered into conservatorship or receivership, in which case the securities would have become worthless. There would have been a risk of loss of investment as the statutorily appointed conservator/receiver may repudiate contracts. In that event, a loss on the transaction would have been suffered by the Taxpayers, who would have been obligated to repay the collateral but who may not have been entitled to receive the full value of the Freddie Mac paper. The Taxpayers would not have had this economic risk if they had simply purchased and sold the Freddie Mac notes in 2001.[10]

A court certainly has the ability to recharacterize a transaction for tax purposes in accordance with its substance. However, the recharacterization cannot

[9] In fact, Refco Inc., Refco's parent, filed for bankruptcy on October 17, 2005. While Refco was not part of the bankruptcy proceedings, it was subsequently unwound and ceased business.

[10] In fact, Freddie Mac was placed in receivership on September 7, 2008.

ignore fundamental economic issues such as counterparty risk. The Tax Court erred in this matter by recharacterizing the transaction as two separate purchases and sales, which totally ignores the economic risk in the transaction.

C. The Tax Court's Recharacterization Erroneously Makes the Transaction More Complex.

The Tax Court's recharacterization of the Transaction is erroneous because it adds steps and complicates the transaction as whole. The Service attempted to invent new steps that never occurred (i.e., additional purchases and sales) and new transactions that never existed (i.e., the forward contract). However, the courts have refused to recharacterize transactions by creating new steps that did not occur and new documents that did not exist. Esmark v. Commissioner, 90 T.C.171, 196-197 (1988) (refusing to recharacterize two actual transactions into two completely fictional transactions because that "recharacterization does not simply combine steps; it invents new ones."); Grove v. Commissioner, 490 F.2d 241, 247 (2nd Cir. 1973) (stating that the IRS "cannot generate events which never took place just so an additional tax might be asserted.").

In the Transaction that actually occurred, the Taxpayers and Refco entered into a securities lending agreement pursuant to actual documents: the Agreement, the Amendment and the Addendum. The Service's recharacterization invents

entirely new steps and documents in order to arrive at the conclusion the Commissioner desires. In the absence of (1) a forward contract, (2) a 2001 sales agreement, or (3) a 2003 purchase agreement, the Service is constrained to rely on the stipulated documents which are in the record. Those agreements, the actions of the parties and the economic realities of the Transaction all reflect that the Taxpayers loaned the Securities to Refco in 2001, which Refco was obligated to return in 2003. Thus, the Tax Court erred when it recharacterized the Transaction by adding steps that made it more complex.

V. THE TAX COURT FAILED TO CHARACTERIZE ACCURATELY THE TAX CONSEQUENCES OF TERMINATING THE FORWARD CONTRACT.

In the alternative, assuming *arguendo* that the recharacterization of the Transaction was correct, the Taxpayers would still be entitled to long-term capital gain treatment and interest deductions because the Tax Court failed to give its recharacterization any substance. The Tax Court does not acknowledge that a forward contract is a capital asset, with a holding period and a tax basis. The Tax Court does not integrate the existence of this forward contract into its analysis of the Transaction in 2003. If the recharacterization is accepted, the transfer of funds to the Taxpayers in 2003 is in exchange for the Taxpayers' right to purchase the

Securities at a fixed price. The liquidation of a forward contract generates a capital gain, which would be a long-term gain in this situation.

Section 1234A(1) states that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer is treated as gain or loss from the sale of a capital asset. Among the transactions intended to be covered by the above rules are cancellations of forward contracts for currencies or securities. S. Rept. No. 97-144 (PL 97-34) at 170. Thus, any gain or loss arising from the settlement of obligations under a forward contract (including a payment pursuant to the terms of the obligations) is treated as gain or loss from a termination of the forward contract. See Prop. Reg. § 1.1234A-1(c)(1). When Refco terminated the illusory forward contract by paying the Taxpayers the fair market value of the Securities in January 2003, the resulting gain would have been long-term capital gain to the Taxpayers.

The payment of the fair market value should be considered a cancellation or termination payment that extinguished the Taxpayers' contractual right to the Securities. In Wolff v. Commissioner, 148 F.3d 186 (2nd Cir. 1998), the taxpayers closed out securities forwards contracts, on which they were suffering economic

losses, by simply paying cancellation fees which reflected the economic losses. The court ruled that the resulting cancellations were not sales or exchanges and that, therefore, the transactions resulted in ordinary losses. The cancellations at issue in Wolff occurred in tax years before the effective date of section 1234A, and the court expressly noted that Congress' purpose behind enacting section 1234A was to treat gains or losses from the cancellation of forward contracts for currencies or securities as capital gains or losses.

Similar to Wolff, Refco paid a cancellation fee at the termination of the loan equivalent to the economic gain on the Securities (the Securities fair market value less the cash collateral received back, which was equal to the Securities purchase price, i.e., the economic gain). Subsequent to the cancellation payment, the Taxpayers had no rights to purchase the Securities from Refco. Nothing in the stipulated facts indicates that the Taxpayers at any time purchased or were in possession of the Securities in 2003. Thus, Refco's cancellation fee of the illusory forward contract would be a capital gain under section 1234A.

Moreover, even if the cash transferred in 2001 is characterized as sale proceeds rather than cash collateral, that tax fact does not change the real-life fact that the Taxpayers were obligated to repay the cash to Refco with what has been

treated as interest.[11] The Taxpayers incurred an indebtedness in 2001 that would not have been questioned as indebtedness had the Transaction qualified for nonrecognition under section 1058. The fact that section 1058 does not apply under the Tax Court's recharacterization cannot change the real-life relationship between the Taxpayers and Refco: the Taxpayers were obligated to return the cash collateral with interest. If, under the Tax Court's recharacterization, there was no securities loan, then the obligation was to pay for the forward purchase of the securities, with interest. See "What Were They Thinking? Stock Lending and Samueli," 125 *Tax Notes* 143 (Oct. 5, 2009).

There is nothing in the tax law that should prevent such an obligation from producing deductible interest, at least when paid in cash. For example, the court in Halle v. Commissioner, 83 F.3d 649 (4th Cir. 1996), ruled that the taxpayer could

[11] Although commonly assumed to be deductible interest, the characterization of the interest-like payments the securities lender may have to pay to the borrower on cash collateral is not all that clear. The Supreme Court in Provost made clear the difference between a loan secured by the pledge of securities and a lending of those securities against cash collateral. Under the principle of Deputy v. Du Pont, 308 U.S. 488 (1940), it would seem that the holder of the cash collateral did not hold it as a borrower and so could not pay interest that would be deductible as such (it might be deductible as something else). Nevertheless, the Supreme Court in Provost referred to those payments as interest, and that seems to have been the Service's operating assumption. See, e.g., Priv. Ltr. Rul. 8011100 (Dec. 21, 1979) (assumed interest).

deduct interest paid on an obligation to purchase stock in the future, disagreeing with the Service's argument that the contract created an option. Thus, the indebtedness incurred by the Taxpayers and corresponding interest payments must be respected.

CONCLUSION

For the reasons set forth above, the Judgment of the Tax Court should be reversed.

STATEMENT OF RELATED CASES

This case has not previously been before this or any other appellate court. Counsel for the Petitioners-Appellants are not aware of any pending cases that will directly affect or be directly affected by this Court's decision in this appeal.

Respectfully submitted,

s/ Robert S. Walton

Robert S. Walton
Richard M. Lipton
BAKER & McKENZIE LLP
130 East Randolph Drive
Chicago, IL 60601
(312) 861-2540

Counsel for Petitioners-Appellants,
Henry Samueli and Susan F. Samueli,
and Thomas G. and Patricia W. Ricks

Dated this 23rd day of October, 2009

CERTIFICATE OF SERVICE

Ninth Circuit Case Numbers: 09-72457 and 09-72458

I hereby certify that I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system on October 23, 2009.

I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system.

s/ Robert S. Walton

Robert S. Walton
BAKER & McKENZIE LLP
130 East Randolph Drive
Chicago, IL 60601
(312) 861-2540

Counsel for Petitioners-Appellants,
Henry Samueli and Susan F. Samueli,
and Thomas G. and Patricia W. Ricks

Dated this 23rd day of October, 2009

CERTIFICATE OF COMPLIANCE

Certificate of Compliance Pursuant to Fed. R. App. P. 32(a)(7)(C) and Circuit Rule 32-1 for Case Numbers 09-72457 and 09-72458.

I certify that pursuant to Fed. R. App. P. 32 (a)(7)(C) and Ninth Circuit Rule 32-1, the attached opening brief is proportionately spaced, has a typeface of 14 points or more and contains 13,027 words.

s/ Robert S. Walton
Robert S. Walton
BAKER & McKENZIE LLP
130 East Randolph Drive
Chicago, IL 60601
(312) 861-2540

Counsel for Petitioners-Appellants,
Henry Samueli and Susan F. Samueli,
and Thomas G. and Patricia W. Ricks

Dated this 23rd day of October, 2009