11-10395

In the
United States Court of Appeals
For the Eleventh Circuit

LIZZIE W. CALLOWAY,

Petitioner-Appellant,

– v. –

COMMISSIONER OF IRS,

Respondent-Appellee.

UNITED STATES OF AMERICA TAX COURT

BRIEF FOR PETITIONER-APPELLANT

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CERTIFICATE OF INTERESTED PERSONS

Pursuant to Eleventh Circuit Rule 26-1, appellants provide the following list of persons who have an interest in the outcome of this appeal:

Calloway, Albert L., Appellant/Petitioner

Calloway, Lizzie W., Appellant/Petitioner

Colvin, John O., Chief Judge United States Tax Court

Cohen, Mary Ann, Judge United States Tax Court

Commissioner of Internal Revenue, Appellee/Respondent

Di Trolio, Robert R., Attorney Appellee/Respondent

Gale, Joseph H., Judge United States Tax Court

Goeke, Joseph Robert, Judge United States Tax Court

Gustafson, David, Judge United States Tax Court

Halpern, James S., Judge United States Tax Court

Holmes, Mark V, Judge United States Tax Court

Isaacson, Brian G., Attorney for Appellants/Petitioners

Kroupa, Diane L, Judge United States Tax Court

Marvel, L. Paige, Judge United States Tax Court

Parent, Daniel J., Attorney for Appellee/Respondent

Paris, Elizabeth Crewson, Judge United States Tax Court

Rothenberg, Gilbert S., Attorney for Appellee/Respondent

Ruwe, Robert P., Judge United States Tax Court

Thornton, Michael B., Judge United States Tax Court

Weiner, Andrew, Attorney for Appellee/Respondent

Wells, Thomas B., Judge United States Tax Court

Wherry, Robert A., Judge United States Tax Court

Wilkins, William J., Internal Revenue Service

STATEMENT REGARDING ORAL ARGUMENT

Appellants request oral argument because this case, which is on appeal from the United States Tax Court, involves an issue of first impression. [Dkt 48, pg 11].

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I. JURISDICTIONAL STATEMENT

Pursuant to I.R.C. § 7442[1], the United States Tax Court had subject matter jurisdiction over the Petition filed by Lizzie W. and Albert L. Calloway, Petitioners/Appellants (hereinafter "Calloway"), Georgia residents, against the Commissioner of Internal Revenue, Respondent/Appellee ("IRS"), for the redetermination of the correct amount of the tax reported in the Notice of Deficiency for tax year 2001, which was issued by the IRS on April 9, 2007. [Dkt 38, Ex. 2J].

The United States Courts of Appeals has exclusive jurisdiction to review the decisions of the Tax Court in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury. I.R.C. § 7482(a)(1). Venue is in the Eleventh Circuit based on the location of Calloway's residency under I.R.C. § 7482(b)(1)(A).

The Calloway's timely filed his Notice of Appeal on January 20, 2011 pursuant to I.R.C. § 7502, [Dkt. 54] after the Tax Court took the following action: (1) issued 135 T.C. No. 3, on July 8, 2010, and (2) entered the Final Decision on October 26, 2010. [Dkt 48, pg 2]. This appeal is from a final order that disposes of all the parties' claims.

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[1] The Internal Revenue Code ("I.R.C.") is codified in Title 26 of the United States Code.

II. STATEMENT OF THE ISSUES

(1) Is Calloway taxed on the sale of his shares in 2004 or 2001? In 2001 the Calloway's transferred 990 shares of IBM stock to a custodial account under the care of Derivium Capital LLC. (hereinafter "Derivium") and entered into a letter of intent to pledge the stock as collateral for a loan. Derivium failed to fund a loan. Instead, Derivium sold the Calloway's stock without his knowledge; transferred 90% of the sale proceeds to the Calloway's, and created false reports which concealed that Derivium had sold the stock. The contract gave the Calloway's the right to terminate the agreement and obtain the right to the immediate return of their shares until 2004.

(2) Did the Tax Court err by imposing penalties in 2001 when Calloway did not even know that his stock had been sold?

III. STATEMENT OF THE CASE

The Calloway's filed their 2001 tax return late on February 11, 2004. The Calloway's reported tax liability for 2001 of $21,171. [Dkt. Ex. 1-J] They did not report the gain from the sale of their 990 shares of IBM stock on deposit in a custodial account with Derivium in 2001 because they did not know that their

shares had been sold.[2] [Dkt. 48, pg 65]. On April 9, 2007, the IRS issued a Notice of Deficiency for tax year 2001, assessing a deficiency of $30,911 and a penalty under I.R.C. § 6651(a)(1) of $6,583 and a penalty under I.R.C. § 6662(a) of $6,182. [Dkt. 38, Ex. 2-J]. The Caloway's challenged the Notice of Deficiency by filing a Petition to the United States Tax Court on April 13, 2007. [Dkt 1].

The Tax Court issued its opinion in favor of the government on July 8, 2010. [Dkt. 48]. The Court held:

(1) The transaction between Calloway and Derivium in August 2001 was a sale because Calloway transferred all the benefits and burdens of ownership of the stock to Derivium for $93,586.23 with no obligation to repay that amount;

(2) The transaction was not analogous to the securities lending arrangement in Re. Rul. 57-451, 1957-2 C.B. 295, nor was it equivalent to a securities lending arrangement under I.R.C. § 1058;

(3) Calloway is liable for an addition to tax under I.R.C. § 6651(a)(1), for the late filing of their 2001 Federal income tax return; and

[2] In the concurrence Judge Holmes stated, "Calloway testified that he did not know Derivium had sold the stock and that Derivium sent out quarterly lies that it still held the collateral and credited the amount of dividends paid to reduce Calloway's interest obligations." [Dkt. 48, pg 65].

(4) Calloway is liable for the accuracy-related penalty pursuant to I.R.C. § 6662. [Dkt. 48, pg 2].

Calloway filed his Notice of Appeal on January 20, 2011. [Dkt. 54].

IV. STATEMENT OF FACTS

Albert L. Calloway signed an Agreement with Deriviuim Capital on August 8, 2001. [Dkt. 38, Ex. 3J]. On or about August 9, 2001, Calloway instructed Brian J. Washington of First Union Securities, Inc., to transfer 990 shares of IBM common stock (IBM stock or collateral) to Morgan Keegan & Co. (Morgan Keegan) and to credit Derivium's account. [Dkt. 48, p. 7]. Charles D. Cathcart signed the Agreement on August 10, 2010. [Dkt. 38, Ex. 3J]. On August 16, 2001, Morgan Keegan credited Derivium's account with the IBM stock transferred from Calloway. [Dkt. 47, p. 7].

The following day, August 17, 2001, Derivium sold the 990 shares of IBM stock held in its Morgan Keegan account for $103,984.65 (i.e., $105.035 per share of IBM common stock). The net proceeds from Derivium's sale of the IBM stock were $103,918.18 (i.e., $103,984.65 minus a $3.47 "S.E.C. Fee" and a $63

"Commission"). [Dkt. 47, p. 7]. Calloway testified that he did not know Derivium had sold the stock. [Dkt. 48, pg 65].[3]

On August 21, 2001, Derivium sent to Calloway a letter informing him that the proceeds of a loan were sent to him according to the wire transfer instructions he had provided a few days earlier. On that same date, a $93,586.23 wire transfer was received and credited to Calloway's account at IBM Southeast Employees Federal Credit Union. [Dkt. 48, p. 9].

During the term of the "loan" Derivium provided Calloway with quarterly and year end account statements. The quarterly account statements reported "end-

[3] In response to a question by Judge Ruwe, IRS Counsel, Daniel Parent, stated that the IRS did not produce any documents evidencing that a sale had occurred until November 2007. [Dkt. 40, Tr. pg. 59, lines 8-13].

Judge Ruwe: When did you first produce these documents to Mr. Isaacson?

Mr. Parent (IRS Counsel): They were included in the first stipulation of facts that was sent to Mr. Calloway in November 2007.

Mr. Calloway confirmed that he had not received any evidence to question his belief that his 990 shares of IMB were not sold in November 2001.

Mr. Isaacson: Have you seen any of these records [indicating that a sale had occurred] before Mr. Parent gave them to you through your attorney?

A. (Calloway) No.

of-quarter collateral value" and dividends such that it appeared that Derivium still held the IBM stock (i.e., Derivium appears to have reported the value of the collateral on the basis of the fair market value of the IBM stock at the end of each calendar quarter rather than the $103,984.65 of sale proceeds, and further reported dividends on the IBM stock, which it credited against the interest accrued during the quarter, as if it continued to hold all 990 shares of IBM stock). The Calloways neither received a Form 1099-DIV, Dividends and Distributions, nor included any IBM dividend income from the alleged dividends paid on the IBM stock on their 2001, 2002, 2003, or 2004 Federal income tax returns. [Dkt. 48, p. 9].

In a letter dated July 8, 2004, Derivium informed Calloway that the loan "will mature on August 21, 2004" and that the "total principal and interest that will be due, and payable on the Maturity Date is $124,429.09." The letter also informed Calloway that, as of July 8, 2004, the value of 990 shares of IBM stock was $83,318.40. Derivium also reiterated to Calloway that, pursuant to the terms and conditions of the master agreement, he was entitled to elect one of the following three options at maturity: (1) "Pay the Maturity Amount and Recover Your Collateral"; (2) "Renew or Refinance the Transaction for an Additional Term"; or (3) "Surrender Your Collateral." [Dkt. 48, p. 9-10].

On July 27, 2004, Calloway responded to Derivium's July 8, 2004, letter, stating that "I/we hereby officially surrender my/our collateral in satisfaction of

my/our entire debt obligation"; i.e., Calloway relinquished his right to the return of his IBM stock valued at $83,326.32. [Dkt. 48, p. 10].

On February 11, 2004, the Calloways filed their 2001 joint Federal income tax return. Petitioners did not report the $93,586.23 received from Derivium in exchange for the IBM stock on their 2001 Federal income tax return, nor did they report the termination of the transaction with Derivium on their 2004 Federal income tax return. [Dkt. 48, p. 11].

The Calloway's cost basis in the 990 shares of IBM stock was $21,171. [Dkt. 48, p. 11].

V. SUMMARY OF THE ARGUMENT

Calloway transferred his stock to a Custodial Account whereby Derivium agreed to act as custodian over the account. Derivum did not make a loan to Calloway. Derivium did not have the right to sell Calloway's stock. Calloway had the right to terminate the Custodial Account Agreement at any time prior to the funding of a loan. Calloway did not know that Derivium had disposed of his shares in 2001 until the IRS asserted a tax deficiency in 2007. Derivium offered to return Calloway's shares in a letter dated July 8, 2004.

The Majority's finding of fact that Derivium was given the immediate right to sell Calloway's stock upon transfer to Derivium is clearly erroneous. The

Majority's finding of fact that Calloway was prohibited from demanding the return of his stock during the 3-year period is also clearly erroneous.

Calloway is eligible for the safe harbor under I.R.C. § 1058 from the non-recognition of gain or loss on his transfer of stock to Derivium in 2001 because Calloway had the right to terminate the Custodial Agreement with Derivium and obtain the return of his stock.

Calloway is also eligible for the safe harbor under Rev. Rul. 57-451, which holds that a party who deposits his stock in a brokerage account and retains the right to terminate the account agreement and demand the return of his stock does not dispose of his stock under the Code.

The appropriate standard to use in this case to determine whether a sale occurred in 2001 is the control test articulated by the United States Supreme Court in *Richardson v. Shaw* as opposed to the standard articulated in *Grodt v. McKay*. In this case, the account agreement provided that Calloway would remain in control of the stock and provided that Derivium would not have the authority to transfer or dispose of Calloway's stocks until there was a legitimate loan in place. The condition precedent that there be a legitimate loan in place before Derivium would have the power to transfer or dispose of Calloway's stocks failed to occur. The *Richardson v. Shaw* test is appropriate because it is intended to apply where

there has been a transfer to a margin account and the broker does not have the authority to immediately sell the stock.

The Calloways are entitled to the reasonable cause exception from penalties under I.R.C. § 6662 because they reasonably relied upon reports issued by Derivium that their shares had not been sold in 2001, and because they did not know that their stock had been sold in 2001. In addition, the Service failed to provide its reasons for imposing a penalty during the administrative process in order to have standing to argue for the imposition of the penalty in 2001.

VI. ARGUMENT AND CITATIONS OF AUTHORITY

1. Standard of Review

The Tax Court's legal conclusions are reviewed *de Novo* and its findings of fact are reviewed for clear error. *Atlanta Athletic Club v. Commissioner*, 980 F.2d 1409, 1412 (11thCir. 1993). The Tax Court's determination of the activities that took place, are factual findings. A finding of fact is clearly erroneous if the record lacks substantial evidence to support it such that a review of the entire evidence of the record leaves the Court with the definite and firm conviction that a mistake has been committed. *Id.*

2. The Majority entered a factual finding that Derivium did not make a loan to Calloway.

In the Opinion, *Calloway v. Commissioner*, 135 T.C. No. 3 (2010), the majority of the Tax Court, consisting of Judges Ruwe, Colvin, Cohen, Wells, Gale, Thornton, Marvel, Goeke, Kroupa, Gustafson, and Paris relied upon *United States v. Cathcart*, 104 AFTR 2d 2009-6625, 2009-2 USTC par. 50,658 (N.D. Cal. 2009) to reach their conclusion that Derivium did not make a loan to Calloway. [Dkt. 48, p. 21-26].

United States v. Cathcart was an action against Charles D. Cathcart, the President of Derivium Capital, to enjoin him from promoting the 90-percent-stock-loan-program and to impose I.R.C. § 6700 penalties because he had made fraudulent statements regarding the program. Cathcart stipulated to the entry of a permanent injunction. [Dkt. 48, p. 24]. In her order dated September 22, 2009, Judge Hamilton ruled:

> The court found that the undisputed evidence revealed that: as part of the loan transaction in question, legal title of a customer's securities transfers to Derivium USA (for example) during the purported loan term in question, which vests possession of the shares in Derivium's hands for the duration of the purported loan term; that the customer must transfer 100% of all shares of securities to Derivium USA **and that once transferred, Derivium USA sells those shares on the open market, and that once sold, Derivium USA transfers 90% of that sale amount to the customer as the "loan" amount, keeping 10% in Derivium USA's hands** . . .. [Dkt 48, p. 25].

Judge Hamilton concluded that analysis of these and other undisputed facts pursuant to either the benefits/burdens approach outlined in *Grodt & McKay Realty, Inc. v. Commissioner of Internal Revenue*, 77 T.C. 1221, 1236 (1981), or

the approach outlined in *Welch v. Comm'r*, 204 F.3d 1228, 1230 (9th Cir. 2000), compelled the conclusion that the transactions in question constituted sales of securities, rather than bona fide loan transactions. See e.g., *Grodt*, 77 T.C. at 1236-37 (applying multi-factor test to determine point at which the burdens and benefits of ownership are transferred for purposes of qualifying a transaction as a sale); Welch, 204 F.3d at 1230 (examining factors necessary to determine whether a transaction constitutes a bona fide loan). [Dkt 48, p. 26].

In the Calloway Opinion, the majority made a factual finding that immediately upon receipt of the Calloway's stock Derivium sold the stock and transferred 90% of the sale amount to Calloway. [Dkt. 48, P. 21]. Judge Holmes' concurrence described the sale as "Derivium's subsequent secret sale of Calloway's stock to an unrelated party." [ER 48]. The Tax court held that Derivium did not make a loan to Calloway. [Dkt. 48, p. 21-26].

3. The Majority's finding of fact that Derivium was given the immediate right to sell Calloway's stock upon transfer to Derivium is clearly erroneous.

The Majority's finding of fact that Derivium was given the immediate right to sell Calloway's stock upon transfer to Derivium is clearly erroneous. [Dkt. 48, p. 4-9, 15-22].

Derivium did not have the right to sell Calloway's stock in order to fund the purported 90% loan. Paragraph 3 specifies that the right of sale is not effective until the period covered by the loan (until there is a loan in place). Although portions of Paragraph 3 are quoted on page 4 of the Tax Court's Opinion, [Dkt. 48, p. 4], the full text of paragraph 3 of the Agreement states:

> FUNDING OF LOAN
>
> **The contemplated Loan(**s) will be funded according to the terms identified in one or more term sheets, which will be labeled as Schecule A, individually numbered and signed by both parties, and on signing, will be considered as part of an merged into this Master Agreement. The Client understands that by transferring securities as collateral to DC and under the terms of the Agreement, the Client gives DC and/or its assigns the right, without requirement of notice to or consent of the Client, to assign, transfer, pledge, repledge, hypothecate, rehypothecate, lend, encumber, short sell and /or sell outright some or all of the securities **during the period covered by the loan.**

Read together, these terms clearly state that Derivium's right to sell Calloways' pledged securities does not begin until there is first a legitimate loan in place. It was a breach of the Master Agreement [Dkt. 38, Ex. 3J] and Schedule A-1 [Dkt. 38, Ex. 4J] for Derivium to sell Calloway's stock. The terms of the agreement did not, as the Court erroneously stated, authorize Derivium to sell Calloway's stock immediately upon receipt. [Dkt. 48, p. 4-9, 15-22].

The Majority entered the following findings of fact which establishes that Derivium sold Calloway's stock before the period covered by the loan, which was in breach of the Agreement.

- On August 16, 2001, Morgan Keegan credited Derivium's account with the IBM stock transferred from Calloway. [Dkt. 48, p. 7].
- The following day, August 17, 2001, Derivium sold the 990 shares of IBM stock held in its Morgan Keegan account for $103,984.65 (i.e., $105.035 per share of IBM common stock). The net proceeds from Derivium's sale of the IBM stock were $103,918.18 (i.e., $103,984.65 minus a $3.47 "S.E.C. Fee" and a $63 "Commission"). [Dkt. 48, p.8].
- The commencement date of the purported three year loan was August 11, 2011. [Dkt. 48, p. 8]
- The purported loan amount was not determined until after Derivium Sold the IBM stock. [Dkt. 48, p. 9].

4. The Majortiy's finding of fact that Calloway was prohibited from demanding a return of his stock during the 3-year period is clearly erroneous.

The Majority's finding of fact that the Calloways were prohibited from demanding a return of his stock during the 3-year period, and therefore, was bereft of any opportunity for gain during the three year period is clearly erroneous. Dkt. 48, p. 18, 19, 23, 29, 31, 32].

The Master Agreement to Provide Financing and Custodial Services, Paragraph 13 signed by Albert L Calloway and Charles D. Cathcart, as president of Derivium Capital states:

> This agreement may be terminated by either party at any time prior to the funding of a loan, in whole or in part and as cash or as credit to cover any existing obligation. [Dkt. 38, Ex. 3J].

Because there was no loan, the Calloways had the right to terminate the Agreement at any time upon demand. Under Paragraph 13, Derivium was required to return Calloway's stock immediately after restoring Derivium to the same economic position that they occupied before the transaction. [Dkt. 38, Ex. 3J].

In this case, the restrictions under the loan agreement never became operative. [Dkt. 38, Ex. 3J]. Derivium's obligation to return Calloway's stock upon demand continued until July 8, 2004, when Calloway entered into a separate agreement to surrender their stock in satisfaction of their entire obligation. [Dkt. 38, Ex. 12J, 13J].

5. Calloway's initial transfer to Derivium qualifies for the safe harbor for nonrecognition of gain or loss under I.R.C. § 1058

I.R.C. § 1058(a) provides a safe harbor for the nonrecognition of gain or loss when securities are transferred under certain agreements as follows:

> In the case of a taxpayer who transfers securities * * * pursuant to an agreement which meets the requirements of subsection (b), no gain or loss shall be recognized on the exchange of such securities by the taxpayer for an

> obligation under such agreement, or on the exchange of rights under such agreement by that taxpayer for securities identical to the securities transferred by that taxpayer.

I.R.C. § 1058(b) requires the securities agreement to meet the following four requirements in order to qualify for nonrecognition:

> Agreement Requirements.—In order to meet the requirements of this subsection, an agreement shall—
>
> (1) provide for the return to the transferor of securities identical to the securities transferred;
>
> (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.

In this case, the Majority reached the conclusion of law that Calloway did not satisfy the safe harbor requirements under I.R.C. § 1058. [Dkt. 48, p. 27-32]. The Court stated:

> In order to meet the requirements of section 1058(b)(3), the agreement must give the person who transfers stock "all of the benefits and burdens of ownership of the transferred securities" and the right to "be able to terminate the loan agreement upon demand." *Samueli v. Commissioner*, 132 T.C. 37, 51 (2009). In Samueli we focused on the meaning of the requirement in section 1058(b)(3).
>
> > [W]e read the relevant requirement * * * to measure a taxpayer's opportunity for gain as of each day during the loan period. A taxpayer

> has such an opportunity for gain as to a security only if the taxpayer is able to effect a sale of the security in the ordinary course of the relevant market (e.g., by calling a broker to place a sale) whenever the security is in-the-money. A significant impediment to the taxpayer's ability to effect such a sale * * * is a reduction in a taxpayer's opportunity for gain. [Id. at 48.]

> Petitioner was bereft of any opportunity for gain during the 3-year period because he could reacquire the IBM stock only at maturity. Schedule D of the master agreement not only provides that Derivium had the "right, without notice to * * * [petitioner], to transfer, pledge, repledge, hypothecate, rehypothecate, lend, short sell, and/or sell outright some or all of the securities during the period covered by the loan", but also provides that Derivium "has the right to receive and retain the benefits from any such transactions and that * * * [petitioner] is not entitled to these benefits during the term of a loan." Because petitioner was prohibited from demanding a return of any stock during the 3-year period, his opportunity for gain was severely diminished. See *Samueli v. Commissioner*, supra at 48. Accordingly, we hold that the transaction is not analogous to the second situation in Rev. Rul. 57-451, supra, and is not an arrangement that meets the requirements of section 1058

If the Court of Appeals determines (1) that th**e** Majority's finding of fact that Derivium was given the immediate right to sell the Calloway's stock upon transfer to Derivium is clearly erroneous, and (2) that th**e** Majority's finding of fact that the Calloway's were prohibited from demanding the return of their stock during the 3-year period is clearly erroneous, then the Court should determine that as a matter of law, Calloway satisfied the safe harbor rule under I.R.C. § 1058.

As explained above, the loan provisions of the Custodial Agreement, which gave Derivium the right to hold the Calloway's stock for the three year term, and which gave Derivium the right to sell Calloway's shares without notice were never

operative. The Calloway's had the right to the return of their stock at any time prior before there was an operative loan. Calloway qualifies for the safe harbor under I.R.C. § 1058(a) and (b).

6. The Calloway's initial transfer to Derivium qualifies for the safe harbor for nonrecognition of gain or loss under Rev. Rul. 57-451.

By the enactment of I.R.C. § 1058, Congress codified and clarified the then-existing law represented by Rev. Rul. 57-451. [Dkt. 48, p. 30]. In Rev. Rul. 57-451; 1957-2 C.B. 295 the Internal Revenue Service held that the following transactions were not dispositions of stock:

> (1) The stockholder deposits his stock with a bank or trust company in an "agency" account and authorizes such company to collect the dividends thereon. Although the stock certificate remains in the stockholder's name, for convenience the stockholder signs a stock assignment form in blank, enabling the bank or trust company to dispose of the shares upon subsequent order of the stockholder.
>
> (2) The stockholder deposits his stock with his broker in a "safekeeping" account and, at the time of deposit, endorses the stock certificates and then authorizes the broker to "lend" such certificates in the ordinary course of the broker's business to other customers of the broker. The broker has the certificates cancelled and new ones reissued in his own name.
>
> (3) Same as (2) above, except that the stockholder does not authorize the broker to "lend" the securities to other customers and the certificates remain in the stockholder's name.

Rev. Rul. 57-451, specifies when a disposition is taxed as follows"

> If the broker, on the other hand, satisfies his obligation by delivering to the optionee stock or other property which does not bring the transaction within

> the scope of Section 1036, the optionee makes a disposition of his stock for purposes of section 421 as of that time.

The Calloway's transaction is analogous to the transactions described in Rev. Rul. 57-451, which holds that a party who deposits his stock in a brokerage account and retains the right to terminate the contract and demand the return of his stock does not dispose of his stock under the Code.[4]

In this case, Derivium offered to return the Calloway's shares in a letter dated July 8, 2004. [Dkt. 38, Ex. 12J]. The Calloway's should not be taxed under I.R.C. § 1036 or Rev. Rul. 57-451 until the date the exchange failed, which occurred on July 27, 2004. [Dkt. 38, Ex. 13J].

7. The appropriate test to use in this case to determine whether a sale occurred at the time Calloway transferred his shares to Derivium is the test articulated by the United States Supreme Court in Richardson v. Shaw.

Judge Halperin argued in his concurrence, with Judge Wherry in agreement, that the appropriate standard to use in this case to determine whether a sale occurred is the test articulated by the United States Supreme Court in *Richardson v. Shaw*, 209 U.S. 365, 28 S. Ct. 512, 52 L. Ed. 835 (1908). Dkt 48, p. 40-43]. Judge Halpern explained his rationale as follows:

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[4] Calloway does maintain that a taxable disposition occurred in 2004. The Commissioner is not prejudiced by the taxable disposition being in 2004, since the Commissioner has the right to collect the taxes from the disposition of the 990 shares of IBM stock in 2004.

In *Richardson v. Shaw*, 209 U.S. 365, 28 S. Ct. 512, 52 L. Ed. 835 (1908), a nontax case, a stockbroker, who held title to the securities in a customer's margin account, had pledged those securities to secure a loan. The broker then filed for bankruptcy. The question before the Court was whether, despite the pledge and the broker's authority to cover its obligation to its customer with securities other than those actually purchased on the customer's behalf, the customer was the owner of the securities and so, on the broker's bankruptcy, did not become merely a creditor of the bankrupt. Focusing on the fungibility of the securities in question and the broker's limited authority to pledge them (and not to sell them except in limited circumstances), the Court concluded that the broker's status was essentially that of a pledgee and that the customer was and remained the owner of the securities. Legal title and the power to dispose were not united in the broker, and the broker was not, therefore, the owner of the securities.

In *Provost v. United States*, 269 U.S. 443, 46 S. Ct. 152, 70 L. Ed. 352, 62 Ct. Cl. 744, T.D. 3811 (1926), a Federal stamp tax case, the question was whether the transfers of stock back and forth between a securities lender and a securities borrower (both stockbrokers) constituted taxable dispositions of the stock. The Court assumed that such transfers usually occurred to facilitate short sales. The securities lender provided the stock to the securities borrower, who delivered it in fulfillment of the agreement of his customer (who was short the stock) to sell it. The lender had the contractual right, on demand (with notice), to receive equivalent stock from the borrower. The Supreme Court sharply distinguished the facts in *Provost* from those in *Richardson v. Shaw*, supra. In *Richardson*, the broker's status as pledgee rather than owner rested on the requirement that the broker have on hand for delivery to its customers stock of the kind and amount that the customers owned. In a securities loan, however:

> The procedure adopted and the obligations incurred in effecting a loan of stock and its delivery upon a short sale neither contemplate nor admit of the retention by * * * the lender of any of the incidents of ownership in the stock loaned. * * * Upon the physical delivery of the certificates of stock by the lender, with the full recognition of the right and authority of the borrower to appropriate them to his short sale contract, and their receipt by the purchaser, all the incidents of ownership in the stock pass to him.

Provost v. United States, supra at 455-456. Notwithstanding that the securities lender retained full market risk on the stock lent, the loan (and

> return) of the stock were considered dispositions, shifting ownership of the stock transferred. As one scholar wrote of the Supreme Court's analysis in Provost:
>
> > The analysis could not be clearer: a pledgee does not become a tax owner of a pledged stock while a borrower does become a tax owner of a borrowed stock because the pledgee has a limited control over the pledged securities while the stock borrower's control is complete. This result obtains even though a stock borrower gains no economic exposure to the borrowed stock, all of which is retained by a lender. In other words, control overrides economic exposure in determining tax ownership of a borrowed stock.
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> Raskolnikov, "Contextual Analysis of Tax Ownership", 85 B.U.L. Rev. 431, 481-482 (2005).[5] [Dkt 48, p. 40-43].

The facts in this case are analogous to *Richardson v. Shaw* and are distinguishable from *Provost*. In *Provost*, the broker acted as a securities lender who was given the authority to dispose of the stock. In *Richardson v. Shaw*, by comparison, the broker was not given the authority to dispose of the stock. In this case, the agreement provided that Calloway would remain in control of the stock and provided that Derivium would not have the authority to transfer or dispose of the Calloway's stocks until there was a legitimate loan in place. [Dkt. 38, Ex. 3J]. As explained above, the condition precedent that there be a legitimate loan in place before Derivium would have the power to transfer or dispose of the Calloway's

[5] Judge Halpern stated "Professor Raskolnikov builds his analysis on a seminal discussion of the fundamental difference between tax ownership of fungible and nonfungible assets by now Professor Edward Kleinbard. See Kleinbard, "Risky and Riskless Positions in Securities", 71 Taxes 783 (1993)."

stocks failed to occur. Derivium did not have the authority to dispose of the Calloway's shares until July 8, 2004. [Dkt. 38, Ex. 12J].

8. The Grodt v. McKay Realty test is not the appropriate test to determine when a sale of fungible securities occurred.

In his concurrence, Judge Halpern strongly disagreed with the Majority that the *Grodt v. McKay Realty* test used by the Majority should be used in this case because the Grodt test was formulated to apply to cattle, not fungible securities. [Dkt. 48, p. 40-43]. Judge Halpern stated:

> Shares of stock of the same class are fungible, and this has given rise to apparently formalistic rules for determining questions of ownership (and, by extension, disposition) of such shares. The traditional, multifactor, economic risk-reward analysis, as argued by the parties, is appropriate for determining tax ownership of nonfungible assets, such as cattle. See Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981). For fungible securities, however, a more focused inquiry—whether legal title to the assets and the power to dispose of them are joined in the supposed owner—has been determinative of ownership for more than 100 years. [Dkt. 48, p. 40-43].

In a separate concurrence, Judge Holmes also strongly disagreed that the Grodt & McKay test should be used in this case to determine when a sale occurred. [Dkt. 48, p. 47-75].

> Deception should have been considered at a minimum under the Grodt & McKay factor regarding the parties' treatment of the transaction, but the majority merely notes that the parties' treatment was inconsistent with a loan because Calloway admitted that he knew he had authorized Derivium to sell his stock. This knowledge, however, is not inconsistent with a nonrecourse loan secured by fungible collateral--such a provision is standard in

> brokerage and custodian account agreements where stock secures a loan. The majority fails to mention that Calloway testified that he did not know Derivium had sold the stock and that Derivium sent out quarterly lies that it still held the collateral and credited the amount of dividends paid to reduce Calloway's interest obligation. That, too, however, was part of the conduct of the parties. [Dkt. 48, pg 65].
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> We should be mindful that the various tests in the caselaw require us to consider the conduct of both parties. But "intent" is not exactly the right word for what we think we should be looking for when one of the parties to a deal is trying to deceive another. Derivium's promises of a secret hedging strategy and its continual flow of false statements to its customers, suggest to any reasonable observer in hindsight that its intent was not to make either a loan or a sale, but a quick theft of 10 percent of the stock's value. [Dkt. 48, pg 71].

Calloway incorporates by reference each of the arguments by Judge Halpern [Dkt .48, p. 40-43] and Judge Holmes [Dkt. 48, p. 47-75] that it was erroneous for the Majority to use the *Grodt v. McKay Realty* test in this case.

In the event that the Court of Appeals is inclined to apply the *Grodt v. McKay Realty* test to the facts of this case, then Calloway respectfully requests that the Court apply the test in light of the determination (1) that th**e** Majority's finding of fact that Derivium was given the immediate right to sell the Calloway's stock upon transfer to Derivium is clearly erroneous, and (2) that th**e** Majority's finding of fact that the Calloway's were prohibited from demanding the return of his stock during the 3-year period is clearly erroneous.

9. The Calloway's are entitled to the reasonable cause exception from penalties under I.R.C. § 6662 because Calloway relied upon falsified reports which omitted to disclose that his stock was sold in 2001.

I.R.C. § 6664(c) provides a reasonable cause exception to the accuracy related penalties under I.R.C. § 6662. I.R.C. § 6664 states:

> No penalty shall be imposed under this part with regard 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.

Treas. Regs. § 1.6664-4 Reasonable cause and good faith exception to section 6662 penalties provides:

> (a) In general. No penalty may be imposed under section 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. Rules for determining whether the reasonable cause and good faith exception applies are set forth in paragraphs (b) through (h) of this section.
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> (b) Facts and circumstances taken into account – (1) In general. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.
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> Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on

> facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice, or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.
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> A taxpayer's reliance on erroneous information reported on a Form W-2, Form 1099, or other information return indicates reasonable cause and good faith, provided the taxpayer did not know or have reason to know that the information was incorrect. Generally, a taxpayer knows, or has reason to know, that the information on an information return is incorrect if such information is inconsistent with other information reported or otherwise furnished to the taxpayer, or with the taxpayer's knowledge of the transaction. This knowledge includes, for example, the taxpayer's knowledge of the terms of his employment relationship or of the rate of return on a payor's obligation.
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> (2) Examples. The following examples illustrate this paragraph (b). They do not involve tax shelter items. (See paragraph (e) of this section for certain rules relating to the substantial understatement penalty attributable to the tax shelter items of corporations.)
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> Example 3. E, an individual, worked for Company X doing odd jobs and filling in for other employees when necessary. E worked irregular hours and was paid by the hour. The amount of E's pay check differed from week to week. The Form W-2 furnished to E reflected wages for 1990 in the amount of $ 29,729. It did not, however, include compensation of $ 1,467 paid for some hours E worked. Relying on the Form W-2, E filed a return reporting wages of $ 29,729. E had no reason to know that the amount reported on the Form W-2 was incorrect. Under the circumstances, E is considered to have acted in good faith in relying on the Form W-2 and to have reasonable cause for the underpayment attributable to the unreported wages.

The Calloway's case is analogous to the taxpayer described in Treas. Regs. § 1.6664-4(b)(2), Example 3, supra, where the taxpayer relied upon an incorrect Form W-2. The record indicates that the Calloways were given quarterly account

statements for 2001 that reported that Derivium still held the IBM stock in 2001. [Dkt. 48, pg 9].

On August 21, 2001, Derivium sent to the Callowoays a letter informing them that the proceeds of the loan were sent to him according to the wire transfer instructions he had provided a few days earlier. On that same date, a $93,586.23 wire transfer was received and credited to petitioner's account at IBM Southeast Employees Federal Credit Union. [Dkt. 48, pg 9].

During the term of the "loan" Derivium provided the Calloways with quarterly and year end account statements. The quarterly account statements reported "end-of-quarter collateral value" and dividends such that it appeared that Derivium still held the IBM stock (i.e., Derivium appears to have reported the value of the collateral on the basis of the fair market value of the IBM stock at the end of each calendar quarter rather than the $103,984.65 of sale proceeds, and further reported dividends on the IBM stock, which it credited against the interest accrued during the quarter, as if it continued to hold all 990 shares of IBM stock). [Dkt. 48, pg 9].

Justice Holmes stated in his concurrence:

> The majority fails to mention that Calloway testified that he did not know Derivium had sold the stock and that Derivium sent out quarterly lies that it still held the collateral and credited the amount of dividends paid to reduce Calloway's interest obligation. That, too, however, was part of the conduct of the parties. [Dkt. 48, pg 65].

I.R.C. § 7491(c) imposes the burden of proof upon the commissioner with respect to the liability of any individual for any penalty. Congress requires the Service to provide its reasons for imposing a penalty during the administrative process in order to have standing to argue for the imposition of the penalty in Court. Congress intended to put an end to the imposition of penalties without considering the reasons for those penalties at the administrative level. *Committee Reports on P.L. 101-239 (Omnibus Budget Reconciliation Act of 1989)* provides:

> The Committee is concerned that the present-law accuracy related penalties (particularly the penalty for substantial understatements of tax liability) have been determined too routinely and automatically by the IRS. The committee expects that enactment of standardized exception criterion will lead the IRS to consider fully whether imposition of these penalties is appropriate before determining these penalties.

In *Fisher v. Comm'r*, 45 F.3d 396, 396-7 (10th Cir. 1995), *nonacquiescence, Fisher v. Commissioner*, 1996-2 C.B. 2, 1996-29 I.R.B. 4 (I.R.S. 1996), the only response to the taxpayer's request from the Commissioner for the abatement of penalties was a supplementary notice of deficiency which failed to offer any reasons for the decision not to abate the penalties. The Court held that, by failing to offer any reasons for the Service's decision not to waive a substantial understatement penalty, the Service failed to demonstrate that the Service had exercised its' discretion and thereby abused its discretion. The Court stated:

> It is an elementary principle of administrative law that an administrative agency must provide reasons for its decisions." *Harberson v. NLRB*, 810

> F.2d 977, 984 (10th Cir. 1987) (citing *SEC v. Chenery Corp.*, 318 U.S. 80, 94, 87 L. Ed. 626, 63 S. Ct. 454 (1943)). The administrative adjudicator, by written opinion, [must] state findings of fact and reasons that support its decision. These findings and reasons must be sufficient to reflect a considered response to the evidence and contentions of the losing party and to allow for a thoughtful judicial review if one is sought. *Public Service Co. of New Mexico v. FERC*, 832 F.2d 1201, 1207 n.5 (10th Cir. 1987) (quoting *Harborlite Corp. v. ICC*, 613 F.2d 1088, 1092 (D.C. Cir. 1979)).
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> By failing to rule specifically on the request for waiver and by failing to offer any reasons for her decision, the Commissioner failed to demonstrate that she had exercised her discretion and thereby abused that discretion. Although the IRS attempted to justify the denial before the Tax Court, this effort was too little, too late. The IRS cannot make taxpayers haul it into Tax Court to ascertain that it has ruled on a lawful request or to discover what the rationale for its decision is.

This case is on point with *Fischer* because the Service imposed the penalty upon Calloway without stating any reasons during the administrative process. It is unfair for the Service to wait until all pleadings have filed to announce a reason for the imposition of penalties. This deprives the Petitioners of the ability of the right to make a meaningful response to the agencies assumptions and arguments. It also allows the Service to offer post hoc rationalizations of the kind forbidden by *Burlington Truck Lines v. U.S.*, 371 U.S. 156, 168-9; 83 S. Ct. 239, 9 L.Ed.2d 207 (1962) where the Court stated: "The Court may not accept appellate counsel's post hoc rationalizations for agency action."

The Majority's rationale for imposing the I.R.C. § 6662 penalty in 2001 was that Calloway did not report the sale of his stock in 2004 when the transaction

closed. [Dkt. 48, p. 35]. This is a post hoc rationalization which was not asserted in the Notice of Deficiency and has no relevance to what the Calloways knew about the sale when he prepared his tax return in 2001. [Dkt. 38, Ex. 2J]. Calloway testified that he did not know Derivium had sold the stock in 2001. [Dkt. 48, pg 65]. Derivium concealed the sale from the Calloways by issuing quarterly account statements which falsely represented that Derivium retained custody of their shares as late as 2004. [Dkt. 48, pg 9].

Although the Calloway's filed their 2001 tax return late on February 11, 2004, they satisfied the reasonable cause and good faith exception under I.R.C. § 6664(c)(1) tax based upon his reliance upon the account statements that Derivium has possession of his shares through 2004 . Calloway's original 2001 tax return claimed a refund of $3,979. [Dkt 38, Ex. 1J]. Except for the IRS's efforts to tax Calloway's transfer of his shares to a custodial account at Derivium as a sale, the effect of the late filing was inconsequential to the government since the Calloways overpaid their taxes in 2001. It is unfair to impose a penalty in 2001 when Calloways did not know that his shares had been sold in 2001. If the IRS intends to assert a penalty for the failure to report the sale, then it should assert the penalty applies in 2004, not 2001.

VII. CONCLUSION

As explained above, Calloway transferred his stock to a Custodial Account whereby Derivium agreed to act as custodian over the account. Derivum did not make a loan to Calloway. Derivium did not have the right to sell Calloway's stock. Calloway had the right to terminate the Custodial Account Agreement at any time prior to the funding of a loan. Derivium offered to return Calloway's shares in a letter dated July 8, 2004.

Calloway respectfully requests that Court of Appeals (1) hold that th**e** Majority's finding of fact that Derivium was given the immediate right to sell Calloway's stock upon transfer to Derivium is clearly erroneous, and (2) hold that th**e** Majority's finding of fact that Calloway was prohibited from demanding the return of his stock during the 3-year period is also clearly erroneous.

Calloway also requests that the Court of Appeals determine as a matter of law that he is eligible for the safe harbor under I.R.C. § 1058 from the non-recognition of gain or loss on his transfer of stock to Derivium in 2001because he had the right to terminate the Custodial Agreement with Derivium and obtain the return of his stock. Calloway also requests that the Court of Appeals determine that he is eligible for the safe harbor under Rev. Rul. 57-451, which holds that a party who deposits his stock in a brokerage account and retains the right to terminate the contract and demand the return of his stock does not dispose of his stock under the Code.

In addition, Calloway requests that the Court of Appeals determine as a matter of law that the appropriate standard to use in this case to determine whether a sale occurred in 2001 is the control test articulated by the United States Supreme Court in *Richardson v. Shaw* as opposed to the standard articulated in *Grodt v. McKay*. In this case, the agreement provided that Calloway would remain in control of the stock and provided that Derivium would not have the authority to transfer or dispose of Calloway's stocks until there was a legitimate loan in place. The condition precedent that there be a legitimate loan in place before Derivium would have the power to transfer or dispose of Calloway's stocks failed to occur. The *Richardson v. Shaw* test is appropriate because it is intended to apply where there has been a transfer to a margin account and the broker does not have the authority to immediately sell the stock.

Finally, Calloway respectfully requests that the Court of Appeals hold that Calloway is entitled to the reasonable cause exception from penalties under I.R.C. § 6662 because he reasonably relied upon reports issued by Derivium that his shares had not been sold and because he did not know that his stock had been sold. In addition, the Service failed to provide its reasons for imposing a penalty during the administrative process in order to have standing to argue for the imposition of the penalty in 2001.

Dated this 14th day of March, 2011.

Respectfully submitted,

/S/

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I hereby certify that my word processing program, Microsoft Word, counted 8,108 words in the foregoing brief, exclusive of the portions excluded by Rule 32(a)(7)(B)(iii).