No. 08-1333

IN THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

CARLOS E. SALA, et al.,

Plaintiffs-Appellees

v.

UNITED STATES OF AMERICA,

Defendant-Appellant

ORAL ARGUMENT REQUESTED

ON APPEAL FROM THE JUDGMENT
OF THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO
JUDGE LEWIS T. BABCOCK

THIS BRIEF HAS ATTACHMENTS
(ATTACHMENTS ARE INCLUDED IN SCANNED PDF FORMAT)

BRIEF FOR THE APPELLANT

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STATEMENT OF RELATED CASES

Pursuant to Tenth Circuit Rule 28.2(C)(1), counsel for the United States advise the Court that they are unaware of any other prior or related appeals.

**IN THE UNITED STATES COURT OF APPEALS
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No. 08-1333

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ORAL ARGUMENT REQUESTED

**ON APPEAL FROM THE JUDGMENT
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JUDGE LEWIS T. BABCOCK**

BRIEF FOR THE APPELLANT

JURISDICTIONAL STATEMENT

Carlos Sala and Tina Zanolini-Sala (taxpayers) timely filed refund claims with the Internal Revenue Service (IRS) in September 2004. (App. 32-34.)[1] *See* 26 U.S.C. ("I.R.C.") § 6511(a). On April 5, 2005, taxpayers timely filed suit on their refund claims in the United States

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[1] "App." references are to the appendix filed with this brief.

District Court for the District of Colorado. (App. 31-82.) *See* I.R.C. § 6532(a)(1). The District Court had jurisdiction under 28 U.S.C.§ 1346(a)(1) and I.R.C. § 7422(a).

The District Court entered judgment in favor of the taxpayers. (App. 165-166.) The United States timely filed a motion for new trial, which the court denied by order entered July 18, 2008. (App. 167-169, 324-334.) The judgment and the order denying the motion for new trial are final decisions that dispose of all parties' claims.

The United States timely filed a notice of appeal on September 12, 2008, appealing both the judgment and the order denying the motion for new trial. (App. 335-337.) *See* 28 U.S.C. § 2107(b); Fed. R. App. P. 4(a)(4)(A)(v). This Court has jurisdiction under 28 U.S.C. § 1291.

STATEMENT OF THE ISSUES

Taxpayers sought to avoid paying any tax on their $60 million of reported income for 2000 by participating in a year-end tax shelter that was grafted onto a legitimate investment program that was to be commenced on the first day of the following year. The District Court held that taxpayers properly deducted their tax shelter loss. The issues presented on appeal are:

1. Whether the District Court erred in holding that the transaction that generated the fictitious (*i.e.*, non-economic) $60 million loss claimed by taxpayers had economic substance.

2. Whether the District Court erred in holding that taxpayers' claimed loss met the requirements for deductibility under I.R.C. § 165.

3. Whether the District Court erred in invalidating Treas. Reg. § 1.752-6, the application of which would eliminate taxpayers' claimed loss.

4. Whether the District Court erred in denying the Government's motion for new trial, where that motion was based on the post-decision recantation of the testimony of one of taxpayers' key witnesses.

STATEMENT OF THE CASE

This is a tax refund case involving aggregate claims of $27,782,950. (App. 35.) Following a bench trial, the District Court entered judgment in favor of the taxpayers on all issues.[2] (App. 165-

[2] One of the issues was whether taxpayers were entitled to recover $1,571,088 of disputed interest. (App. 162-163.) The United States does not appeal that aspect of the District Court's judgment.

166.) The Government moved for a new trial on the basis of a post-decision, sworn recantation of the testimony of one of taxpayers' key witnesses. (App. 167-169.) The court denied the Government's motion, and this appeal followed. (App. 324-334, 335-337.)

STATEMENT OF THE FACTS

A. The Search for a Tax Shelter

Early in 2000, taxpayer Carlos Sala realized more than $58.2 million of income in connection with his exercise of employee stock options. (App. 108.) Taking into account additional interest and dividend income, taxpayers faced the prospect of having to pay tax on more than $60 million of income in 2000. (App. 340.)

In anticipation of his 2000 spike in income, Sala began exploring tax shelter possibilities, including a shelter known as OPIS, with the accounting firm KPMG as early as November 1999.[3] (App. 443.) John Raby of the accounting firm PriceWaterhouseCoopers was also searching for a tax shelter on Sala's behalf around this time, entering

[3] OPIS is an acronym for Offshore Portfolio Investment Strategy. Kristin E. Hickman, *Of Lenity, Chevron, and KPMG*, 26 Va. Tax Rev. 905, 929 (2007).

into a confidentiality agreement for that purpose with the tax shelter-promoting (and now defunct) law firm of Jenkens & Gilchrist in January 2000. (App. 457-459.)

By June of 2000, Sala had tentatively agreed to participate in a tax shelter marketed by KPMG known as BLIPS that would shelter $60 million of income.[4] (App. 444-453.) Ultimately, however, Sala settled on a shelter marketed outside of KPMG by Michael Schwartz, to whom he had been introduced by Raby.[5] (App. 535.) The shelter involved contributing a portfolio of largely offsetting long (purchased) and short (sold) foreign currency options to a short-lived partnership under the premise that the property distributed out of the partnership in liquidation would have a tax basis greatly in excess of its value.[6] That inflated basis would produce an enormous, but wholly artificial,

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[4] BLIPS is an acronym for Bond Linked Issue Premium Structures. Hickman, *supra* note 3, at 925.

[5] KPMG advised Sala on this shelter, and prepared his joint tax return reflecting it, for a fee of $25,000. (App. 454-456, 550-551.)

[6] This shelter purportedly allowed the participant to claim a tax basis in his partnership interest equal to the full purchase price of the long options, even though the net value of the long and short option positions contributed to the partnership was minuscule.

tax loss upon the disposition of the distributed property. (App. 109-110.) The IRS identified this type of transaction (as well as the BLIPS transaction) as abusive in IRS Notice 2000-44, 2000-2 C.B. 255 (released on August 13, 2000), and warned the public that purported losses arising from such transactions would be disallowed. (App. 111.) Sala, well aware of Notice 2000-44, participated in the "offsetting option" tax shelter anyway. (App. 536-540, 542-544, 553-556.)

B. Sala's Choice: The Deerhurst GP Transaction

Schwartz's version of the offsetting option shelter, referred to herein as the Deerhurst GP transaction, had a twist: it would be passed off as an introductory phase to a legitimate long-term investment program managed by Andrew Krieger, a foreign currency trader of some renown. (App. 521-522.) Participants would acquire the necessary offsetting positions and immediately contribute them to a wholly-owned S corporation, which would either hold on to the positions during the so-called "test period" (if a capital loss were desired) or contribute them to a partnership (if an ordinary loss were desired) called Deerhurst Investors ("Deerhurst GP"). (App. 109, 521-522.) Participants were also required at that point to contribute cash equal to 10% of the promised capital loss or 15% of the promised ordinary loss. (App. 522.)

The offsetting options would be closed out before year-end inside Deerhurst GP or the participant's S corporation, as applicable. (App. 424, 521-522.) Under the terms of the arrangement, if the participant's trading account (however held) showed any profit at the end of the year, the participant would be obligated to commit his capital to a long-term investment program to be commenced at the start of the new year through a new entity, Deerhurst Trading Strategies LLC ("Deerhurst LLC"). (App. 371, 521.) Deerhurst GP (and each S corporation that was operating outside Deerhurst GP) would liquidate prior to year-end. (App. 521-522.) For those desiring an ordinary tax loss (*i.e.*, those participating in Deerhurst GP), the liquidating distribution had to include a foreign currency position that the distributee would then immediately terminate. (App. 420, 425-426, 427.)

C. Implementation of the Shelter

On October 20, 2000, Sala opened a trading account at Refco Capital Markets ("Refco") to be managed by Krieger through Deerhurst Management Company, Inc. ("Deerhurst Inc."). (App. 390-391, 523-

531.) Sala's agreement with Deerhurst Inc. (the "Customer Agreement") provides in part (App. 524):

> Customer acknowledges and agrees that Beckenham Trading Company, Inc., an affiliate of Deerhurst ("BTC"), will execute all or a portion of the Currency options and Spot Contract transactions entered into by Deerhurst on behalf of the Account, that BTC will receive mark-ups with respect thereto equal to one and one-half (1½) "PIPs" per roundturn[7] (that is … $150 per $1 million per roundturn) …

Also on October 20, Sala executed subscription documents for Deerhurst LLC. (App. 371-389.) The documents contain no provision that would allow an investor to unsubscribe in the event his "test account" did not show a profit at the end of 2000; indeed, they make no mention whatsoever of the Deerhurst GP transaction. (*Ibid.*) Sala, however, negotiated a side agreement with Schwartz and Krieger, dated November 17, 2000, which allowed Sala to withdraw from Deerhurst LLC without penalty if (1) he had not received an acceptable tax opinion from Brown & Wood LLP "with respect to the transactions that occur in the calendar year 2000" (and for a fee not to exceed $75,000) by March 8, 2001; or (2) he received a statutory notice of deficiency (or a notice of

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[7] The term "roundturn" signifies that the fee applies when the position is established, but not when it is terminated. (App. 565.)

final partnership administrative adjustment) with respect to such transactions. (App. 439-441.)

On October 23, 2000, Sala made an initial deposit of $500,000 into his Refco account. (App. 108-109.) On November 21, Sala deposited an additional $8,425,000 into the account. (App. 109.) From November 24 through November 28, Krieger purchased and sold eleven pairs of largely offsetting foreign currency options (ten of which had one-year maturities) for Sala's account or for allocation among Sala's and other participants' accounts (the "tax trades").[8] (App. 501.) The total purchase price for the long options was $60,976,429, and the total sales price for the short options was $60,259,569, resulting in a $716,860 charge to Sala's account.[9] (App. 501.) The aggregate face amount of the tax trades translated to approximately $3.4 billion. (App. 501, 565-

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[8] The ten one-year option pairs can also be viewed as five "four-sided spreads." (App. 473-478.)

[9] Although both experts discussed an additional "unpaired" long option purchased for Sala's account on Nov. 24 for $11,438 (App. 393, 501), this unpaired option played no part in the creation of the claimed tax loss. See note 6, *supra*. Because this unpaired option had nothing to do with the tax shelter, it should be excluded from any analysis of the "tax trades." We note that both experts excluded this option in determining the maximum potential profit of the tax trades. (App. 437, 502.)

566.) BTC is listed as the broker with respect to each of the tax trades. (App. 501.)

On November 28, Sala assigned his Refco trading account – worth approximately $8.94 million – to his wholly-owned S corporation, Solid Currencies, Inc. ("Solid"). (App. 368, 414.) The assignment document provided that Solid would assign the account to Deerhurst GP in exchange for an interest therein and that "Deerhurst [Inc.] will manage the trading and investment of Deerhurst [GP] pursuant to the terms of the Customer Agreement and will be compensated therefor by [Solid]." (App. 369.) The assignment to Deerhurst GP purportedly took effect on November 30. (App. 414.)

Between December 1 and December 12, Krieger closed out the tax trades by selling options that exactly offset the long options and buying options that exactly offset the short options. (App. 395-396, 397, 400-402, 403-404.) If the close-out of a given long option produced a gain, the close-out of the corresponding short option produced a similar loss, and vice versa. (App. 503.) The gains and losses from these close-out transactions netted a gain between approximately $40,000 and $60,000. (App. 438, 516.)[10]

On December 20, Krieger purchased eleven one-year foreign currency options and entered into eleven one-week foreign currency forward contracts on behalf of Deerhurst GP for inclusion in liquidating distributions to its eleven partners (including Solid) on December 22. (App. 398-399, 417-418.) Although the documentation is conflicting, this much is clear: (1) the liquidating distribution to Solid was worth approximately $9 million (App. 353, 414); and (2) after the distributed foreign currency positions were terminated, Solid's Refco account balance was still approximately $9 million (App. 406).

D. Tax Reporting and Re-Reporting

On its 2000 tax return, Solid reported an ordinary loss of $60,449,984, including a "foreign currency conversion loss" of $60,259,569. (App. 353-354, 358.) As Solid's sole shareholders, taxpayers claimed this $60.4 million loss on their 2000 income tax

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[10] These figures do not include the approximately $50,000 gain realized on the close-out of the unpaired long option referenced in note 9, *supra*. (App. 438.)

return, eliminating all but $26,381 of their reported total income of $60,476,365 for the year. (App. 340, 342-344, 359.)

In an apparent effort to avoid potential penalties of $9.5 million, taxpayers filed an amended 2000 return in November 2003, reducing their claimed loss from $60,449,984 to $56,071, and remitted $26,179,875 of tax and interest to the IRS. (App. 32, 345-352.) After an IRS audit, taxpayers paid an additional $1,603,075, all but $31,987 of which consisted of disputed interest. (App. 32-34.) Taxpayers filed a second amended return in September 2004, reclaiming the tax loss claimed on their original return and seeking a refund of the tax and interest paid with their first amended return (plus $31,987 of the amount they had subsequently paid). (App. 55, 57.) Taxpayers also filed a separate refund claim with respect to the additional disputed interest they had paid. (App. 68.)

E. Proceedings Below

Taxpayers commenced this refund suit after the IRS did not allow their refund claims. (App. 35.) In its defense, the Government asserted, among other things, that taxpayers' shelter loss was precluded by the economic substance doctrine, was not incurred in a profit-motivated transaction, *see* I.R.C. § 165(c)(2), and was eliminated by Treas. Reg. § 1.752-6. (App. 89-92.)

On February 27, 2008 – twelve days before the scheduled start of trial – Jay Fischer, counsel for Andrew Krieger, e-mailed a letter to counsel for both parties, advising them that information provided by Krieger to the U.S. Attorney's office in connection with a criminal tax shelter investigation "may be inconsistent with information [he] provided in [his] depositions" in this case. (App. 102-103.) Specifically, Krieger was now of the view that "the programs in which Mr. Sala was involved were essentially tax driven as opposed to profit driven." (App. 102.) Fischer further indicated by telephone that Krieger was out of the country and would not provide additional sworn testimony in this case until he had finalized an immunity agreement with the U.S. Attorney's office. (App. 98-99.)

Counsel for the Government promptly brought the February 27 letter to the District Court's attention. (App. 95.) At a pre-trial conference on March 5, the Government moved to vacate the trial date, which the court declined to do "based upon a vague and speculative letter." (App. 94-106, 305-306, 313-314.) Government counsel also informed the court that their ethical obligations precluded them from presenting Krieger's deposition testimony at trial. (App. 301.)

On March 11, the second day of trial, the Government objected to the introduction of Krieger's videotaped deposition testimony and offered the February 27 letter into evidence. (App. 556-557.) The court overruled the objection and, on the ground that none of the hearsay exceptions was applicable, refused to admit the letter into evidence. (App. 556, 558-560.) The court also read into the record the contents of a letter dated March 6 that it had received from Mr. Fischer, as well as the contents of correspondence between Fischer and taxpayers' counsel that Fischer had included in his March 6 letter to the court. The first letter, from taxpayers' counsel to Fischer, was dated March 4 and asserts that, in telephone conversations between taxpayers' counsel and Fischer on February 28 and 29, " 'you stated that you were unaware of any false or perjur[i]ous statements of material fact made by Mr. Andrew Krieger in his deposed testimony in the above-referenced matter.' " (App. 276.) In a letter dated March 5 in response, Fischer stood by his February 27 letter: " 'With respect to your letter of March 4, 2008, I refer you specifically to my letter of February 27, 2008 … Any representation that you make to any party as to my characterization of Mr. Krieger's statements must be consistent with my letter of February 27, 2008.' " (App. 276-277.) Finally, in his March 6 letter to the court, Fischer explained that he was forwarding the March 4 and 5 correspondence to the court because " '[Taxpayers' counsel] gave me the clear impression that a conference call would be arranged to enable me to participate in the [March 5] hearing to the extent it dealt with Mr. Krieger's deposition testimony.' " (App. 277.)

On March 12, Fischer e-mailed another letter to counsel for both parties. (App. 220-223.) This letter contained excerpts from Krieger's deposition testimony that a colleague of Fischer believed were inconsistent with statements Krieger had made to the U.S. Attorney's office, as well as additional citations to the deposition transcript representing areas of testimony as to which the U.S. Attorney's office believed Krieger would now testify differently. (*Ibid.*) Counsel for the Government, concluding that the March 12 letter did not overcome the concerns expressed by the District Court with respect to the February 27 letter, elected not to move the court to reconsider its March 11 ruling admitting the Krieger deposition testimony into evidence, nor did either party bring the March 12 letter to the court's attention. (App. 258-259.)

Following trial, the District Court ruled in favor of the taxpayers on all issues in an opinion issued April 22, 2008. (App. 107-164.) In determining that the transaction generating taxpayers' claimed $60 million loss had economic substance and was entered into primarily for profit, the District Court did not regard the relevant transaction to be simply the Deerhurst GP transaction – the specific transaction occurring in 2000 that generated the loss. Instead, the court held that the relevant transaction for these purposes was the entire so-called Deerhurst Program, which, according to the court, included the 5-year Deerhurst LLC investment program that did not commence until the year 2001. (App. 114, 116, 120.)

On May 21, Krieger executed a non-prosecution cooperation agreement with the U.S. Attorney's office. (App. 211.) On the next day, Krieger executed a sworn declaration confirming that "certain portions of my deposition were intentionally false, misleading, and incomplete" and that "[i]f now called upon to testify in Mr. Sala's case, my truthful testimony would be substantially different from my deposition testimony in several areas." (App. 212.) The declaration then provides "[s]ome examples of truthful testimony … with citations to examples of contrary testimony in the deposition." (*Ibid.*)

Among the crucial admissions Krieger made in his post-trial declaration were (1) that the primary purpose of the tax trades was to generate tax losses for the participants and not to generate economic gains; (2) that the transactions that gave rise to the tax losses were not designed to assist in the creation of a profit or for any purpose other than the creation of tax losses; rather, everything that occurred in 2000 consisted of predetermined steps required by Michael Schwartz, the promoter of the tax shelter, all for the purpose of generating a tax basis and a tax loss for the participants; and (3) that there was no sound trading or business reason to liquidate the tax trades by year-end under his trading strategy, and absent the requirement that the trades be liquidated to generate a tax loss in 2000, the currency positions would not have been prematurely unwound. (App. 213-214.)

The Government timely filed a motion for new trial under Fed. R. Civ. P. 59(a) based on Krieger's recantation of his deposition testimony – testimony which the District Court had relied on heavily in reaching its decision. (App. 167-169.) The court, however, denied the motion, and this appeal followed. (App. 324-337.)

SUMMARY OF ARGUMENT

1. The District Court erred in numerous respects in holding that the taxpayers are entitled to deduct their non-economic (and wholly artificial) $60 million tax shelter loss. Central to the court's erroneous decision is its conclusion that the transaction that gave rise to taxpayers' shelter loss in the year 2000 – and thus the transaction to be evaluated for economic substance and profit motive – includes not only the Deerhurst GP transaction, but also the legitimate, 5-year investment program (operated through Deerhurst LLC) that commenced in the year 2001.

The record shows that the Deerhurst GP transaction was a discrete transaction that began in late November 2000 and, as pre-planned, ended about four weeks later. It is undisputed, moreover, that the fictitious $60 million loss at issue was generated solely by the steps comprising the Deerhurst GP transaction. In these circumstances, the District Court was constrained by the decisions of this Court to apply its economic substance and profit motive analyses solely to the Deerhurst

GP transaction. Instead, it lumped that transaction together with the separate (Deerhurst LLC) 5-year trading program and then relied principally on the long-term aspect of the latter to support its ultimate conclusion that the "transaction" creating the tax loss at issue had economic substance and was entered into primarily for profit. In so doing, the court committed reversible error.

2. Once the analysis is properly limited to the Deerhurst GP transaction, the question of economic substance and primary profit motive is not even close. The evidence shows that the Deerhurst GP transaction was nothing more than the abusive, basis-inflating tax shelter described in IRS Notice 2000-44, *supra*. The transaction was designed to create a fictitious $60 million loss in 2000 to offset income of the same amount Sala realized in that year primarily from the exercise of stock options. On the other hand, the limited, theoretical profit that Sala could have realized from the tax trades, which in any event was completely eliminated by fees and transaction costs, was minuscule in comparison to the tax savings of $23 million he expected to receive from his artificial $60 million loss. Thus, as other courts that have addressed essentially the same scheme have concluded, the Deerhurst GP

transaction was an economic sham that should not be recognized for tax purposes.

3. Regardless of the economic substance of, or the profit motivation for, the Deerhurst GP transaction, the $60 million loss claimed by taxpayers on their 2000 return was not a bona fide loss actually sustained, within the meaning of I.R.C. § 165 and the regulations thereunder, and therefore is not deductible in any event. Taxpayers' "loss" was manufactured out of whole cloth and, as such, is not deductible under § 165 or any other provision of the Internal Revenue Code.

4. The District Court further erred in invalidating Treas. Reg. § 1.752-6, which contains a basis-reduction rule that entirely eliminates taxpayers' claimed loss. In concluding that the regulation exceeded the grant of authority to the Secretary of the Treasury contained in 2000 legislation, the court misconstrued the language of the legislation and ignored legislative history indicating that Congress intended to authorize regulations of this type. The court was not writing on a clean slate in this regard; rather, it declined to follow the decision of the Seventh Circuit upholding the validity of the regulation. Moreover, the

court erroneously concluded that § 1.752-6 could not be upheld as a general-authority regulation and that, even if it could, its retroactive feature could not be sustained under the anti-abuse provision of I.R.C. § 7805(b)(3).

5. Finally, the District Court abused its discretion in denying the Government's motion for new trial, which was based on the post-trial declaration by one of taxpayers' key witnesses, Andrew Krieger, that crucial portions of his testimony were false and/or intentionally misleading. Most notably, the court erred as a matter of law in concluding that the portions of Krieger's declaration that directly contradicted his previous testimony – testimony on which the court relied extensively in accepting taxpayers' business-purpose argument – were by definition "merely impeaching" and therefore could not be considered as grounds for a new trial.

ARGUMENT

I

The transaction that generated taxpayers' fictitious $60 million loss lacked economic substance and therefore must be disregarded for tax purposes

Standard of review

The proper application of the economic substance doctrine presents a question of law that this Court reviews *de novo*. *Keeler v. Commissioner*, 243 F.3d 1212, 1217 (10th Cir. 2001). To the extent the District Court's findings of fact are relevant to the proper application of the economic substance doctrine in this case, those findings are reviewed for clear error. *Ibid*.

Issue raised and ruled on

The Government raised the economic substance issue in its Proposed Findings of Fact and Conclusions of Law ("Proposed Findings"). (App. 90.) The District Court ruled on this issue in its Findings of Fact, Conclusions of Law, and Order dated April 22, 2008 ("Opinion"). (App. 113-120, 124-136.)

A. Introduction

1. The Economic Substance Doctrine

"The federal income tax laws do not permit deduction of losses incurred in transactions that lack economic substance." *Keeler*, 243 F.3d at 1217. To have economic substance, a transaction must be "imbued with tax-independent considerations, and … not shaped solely by tax-avoidance features … ." *Ibid.* (quoting *James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1990), in turn quoting *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978)). Application of the economic substance doctrine is appropriate "in cases where the economic or business purpose of a transaction is relatively insignificant in relation to the comparatively large tax benefits." *Rogers v. United States*, 281 F.3d 1108, 1117 (10th Cir. 2002). Consistent with the foregoing, an economic substance analysis typically entails an inquiry into both the economics and the business purpose of the subject transaction. *See James*, 899 F.2d at 908-09 (rejecting a rigid two-pronged test and embracing the "better approach" of considering both economics and business purpose).

The transaction to be analyzed for economic substance is the specific one that gave rise to the claimed tax benefit. *See James*, 899 F.2d at 910; *see also Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1356-57 (Fed. Cir. 2006); *Black & Decker Corp. v. United States*, 436 F.3d 431, 441 (4th Cir. 2006); *Nicole Rose Corp. v. Commissioner*, 320 F.3d 282, 284 (2d Cir. 2003) (per curiam); *ACM P'ship v. Commissioner*, 157 F.3d 231, 260 & n.57 (3d Cir. 1998); *cf. Keeler*, 243 F.3d at 1219-20 (applying same principle in the context of § 165(c)(2)). Thus, suspect transactions "cannot be legitimized merely because they were on the periphery of some legitimate transactions." *James*, 899 F.2d at 910; *see also Basic Inc. v. United States*, 549 F.2d 740, 745 (Ct. Cl. 1977) (taxpayer may not establish business purpose for suspect transaction "simply by showing some factual connection, no matter how remote, to an otherwise legitimate transaction existing at the end of the line").

2. Notice 2000-44 and the Offsetting Option Shelter

In IRS Notice 2000-44, 2000-2 C.B. 255, the IRS identified certain abusive transactions that are designed to manipulate the partnership basis provisions of I.R.C. § 752 so as to create a highly inflated basis in a partnership interest that, upon the taxpayer's exit from the partnership, will generate a large, but wholly artificial, tax loss. These transactions, commonly referred to as "Son-of-BOSS" transactions, were widely marketed to wealthy individuals prior to (and, as this case demonstrates, even after) the issuance of Notice 2000-44.[11] One of the transactions described in Notice 2000-44 involves the contribution of essentially offsetting option positions to a partnership:

> For example, a taxpayer might purchase call options for a cost of $1,000X and simultaneously write offsetting call options, with a slightly higher strike price but the same expiration date, for a premium of slightly less than $1,000X. Those option positions are then transferred to a partnership which, using additional amounts contributed to the partnership, may engage in investment activities.
>
> … [T]he taxpayer claims that the basis in the taxpayer's partnership interest is increased by the cost of the purchased call options but is not reduced under § 752 as a result of the partnership's assumption of the taxpayer's obligation with respect to the written call options. Therefore, … the taxpayer purports to have a basis in the partnership interest equal to the cost of the purchased call options ($1,000X in this example), even though the taxpayer's net economic outlay to acquire the partnership interest and the value of the partnership interest are

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[11] As the name suggests, Son-of-BOSS shelters are an outgrowth of another group of tax shelters known as BOSS (Bond and Option Sales Strategy). *See* Christopher Pietruszkiewicz, *Of Summonses, Required Records & Artificial Entities: Liberating the IRS from Itself*, 73 Miss. L.J. 921, 921 & nn.2-3 (2004).

> nominal or zero. On the disposition of the partnership interest, the taxpayer claims a tax loss ($1,000X in this example), even though the taxpayer has incurred no corresponding economic loss. [2000-2 C.B. at 255.]

Three cases have held that the offsetting option shelter described in Notice 2000-44 lacks economic substance. *See Maguire Partners-Master Investments, LLC v. United States*, 2009 WL 279100 (C.D. Cal. Feb. 4, 2009); *Stobie Creek Invs., LLC v. United States*, 82 Fed. Cl. 636 (2008), *appeal pending*, Fed. Cir. No. 08-5190; *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11 (2007), *appeal pending*, Fed. Cir. No. 08-5045; *see also Cemco Investors, LLC v. United States*, 515 F.3d 749, 751, 752 (7th Cir. 2008) (disallowing loss on the basis of Treas. Reg. § 1.752-6, but noting that the offsetting option shelter at issue there "seems to lack economic substance" and that "all [§ 1.752-6] does is instantiate the pre-existing norm that transactions with no economic substance don't reduce people's taxes"), *cert. denied*, 129 S. Ct. 131 (2008).

The Deerhurst GP transaction, like the transactions invalidated in *Maguire Partners*, *Stobie Creek*, and *Jade Trading* (and the transaction spurned by the Seventh Circuit in *Cemco*), was a version of the offsetting option shelter described in Notice 2000-44. It was designed to produce for Sala (through his S corporation) a highly inflated basis in Deerhurst GP that, in turn, would generate for him (and his wife) a fictitious $60 million loss in the year 2000 upon liquidation of that partnership, thereby sheltering from tax the $60 million in income that Sala and his wife realized in that year. (App. 108-110.) In this regard, the District Court did not hold that the Deerhurst GP transaction itself was imbued with economic substance; rather, it concluded that the Deerhurst GP transaction and the ensuing (legitimate) Deerhurst LLC investment program, viewed as a whole, had economic substance. As discussed below, this misidentification of the transaction to be evaluated for economic substance was a fundamental error of law that directly precipitated the court's erroneous decision in this case.

B. The District Court erred as a matter of law in evaluating the entire so-called Deerhurst Program, rather than the Deerhurst GP transaction, for economic substance

1. The Deerhurst GP transaction, a discrete transaction that took place in the latter part of 2000, indisputably generated taxpayers' fictitious $60 million loss

The record shows that the Deerhurst GP transaction was designed to produce an approximately $60 million ordinary loss for Sala in the year 2000 to offset an equal amount of income that he realized in that year. (App. 108-110.) To achieve this loss, it was imperative that Sala carry out, before the end of the year 2000, a series of pre-planned transactions. (App. 330-331, 424-426.) Indeed, Sala admitted in his testimony that he understood that the various steps comprising the Deerhurst GP transaction would have to be effected before the end of 2000 to eliminate his income for that year. (App. 547, 548-549.) Although it is undisputed that the Deerhurst GP transaction was the transaction that generated taxpayers' fictitious $60 million loss, a basic understanding of the mechanics of this loss-generating scheme is essential to the proper resolution of this case.

In simplified terms, the Deerhurst GP transaction consisted of the following steps: In late November 2000, Sala entered into eleven pairs of foreign currency option contracts, consisting of long positions (with a purchase price of $60,976,429) and essentially offsetting short positions (with a sales price of $60,259,569). (App. 501.) The net cost to Sala of establishing these positions was $716,860. (*Ibid.*) On November 28, Sala contributed the offsetting options to his newly-formed S corporation (Solid). (App. 368.) On or about the same date, Solid contributed the offsetting options to Deerhurst GP in return for an interest in that partnership. (App. 414.) Over the next two weeks, Deerhurst GP closed out the offsetting options (App. 395-396, 397, 400-402, 403-404), resulting in gains and losses that netted to a nominal gain (App. 438, 516). About a week after that, as pre-planned, the tax scheme was completed when Deerhurst GP distributed open foreign currency positions in liquidation and Solid immediately terminated those positions. (App. 353, 406, 414.) Although Sala testified at trial that he realized a net profit in the $60,000 range from his participation in the Deerhurst GP transaction (App. 541), on his 2000 tax return he claimed an ordinary loss of more than $60 million resulting from that transaction (App. 340, 343-344).

Mechanically, the claimed $60 million loss arose as follows: Sala claimed a cost basis of $60,976,429 in the long options, and that basis followed the long options into Solid's hands when Sala contributed the option pairs to Solid. *See* I.R.C. §§ 362(a), 1371(a). When Solid, in turn, contributed the option pairs to Deerhurst GP, Solid included its basis in the long options ($60,976,429) in determining its basis in the partnership interest received, *see* I.R.C. § 722, even though the net value of the option pairs contributed was only $716,860. Solid and Deerhurst GP did not, however, treat Deerhurst GP's assumption of Solid's $60,259,569 obligation with respect to the contributed short options – *i.e.*, the obligation to credit the premiums paid by the purchasers of those options against the exercise price should the purchasers elect to exercise their options – as a liability for purposes of the partnership basis rules. Accordingly, when Deerhurst GP effected an extinguishment of that obligation by closing out the short options, there was no corresponding reduction in Solid's basis in its Deerhurst

GP interest. *See* I.R.C. §§ 752(b), 733(1).[12] Instead, Solid's basis in its Deerhurst GP interest continued to dwarf the value of the assets it contributed to Deerhurst GP – and therefore the value of its interest in Deerhurst GP – by $60,259,569.

When Deerhurst GP liquidated a few days later, Solid's inflated basis in its partnership interest attached to the open currency positions it received in its liquidating distribution. *See* I.R.C. § 732(b). Due to the tax rules applicable to foreign currency transactions, *see* I.R.C. § 988(a)(1)(A), the artificial $60,259,569 loss generated by Solid's termination of the inflated-basis currency positions was ordinary (as opposed to capital) in nature. That loss flowed through to taxpayers' 2000 tax return pursuant to § 1366(a).

Notwithstanding that the Deerhurst GP transaction was a discrete, year 2000 transaction that was the exclusive source of the $60 million "loss" at issue in this case, the District Court, in determining whether the transaction generating that loss had economic

[12] Our analysis of Treas. Reg. § 1.752-6 contains a more comprehensive discussion of the partnership basis rules. See Part III.A.2., *infra*.

substance, identified the relevant transaction as the entire so-called Deerhurst Program, comprised of both the Deerhurst GP transaction (closed out in the year 2000) *and* the 5-year Deerhurst LLC investment program that did not commence until the year 2001. (App. 114, 116, 120.) As discussed below, the court erred in doing so, and therefore wrongly concluded that taxpayers were entitled to the tax loss they claimed.

2. The District Court's decision to include the Deerhurst LLC investment program as part of its economic substance analysis contradicts *James* and is internally inconsistent

Although the District Court appropriately cited *James*, 899 F.2d at 910, for the principle that the transaction to be evaluated for economic substance is the one that gave rise to the claimed tax benefit (App. 114), it then proceeded to fundamentally misconstrue that principle by evaluating the entire so-called Deerhurst Program – comprised (according to the court) of both the loss-generating Deerhurst GP transaction and the 5-year Deerhurst LLC investment program – for economic substance. The court did so despite the fact that the investment program did not contribute in any way to the claimed loss, did not commence until the year *after* the Deerhurst GP transaction had been fully completed, and was conducted through a different entity. The court's decision in that regard is especially puzzling in light of its initial resolution to "determine whether the portion of the [Deerhurst] program that created the loss is bona fide." (App. 113.) That statement, coupled with the court's acknowledgment (App. 116) that "the Deerhurst LLC portion had no tax benefits," would seem to confirm the obvious: that "the transaction that gave rise to the particular tax benefit" (App. 114) in this case – and therefore the transaction to be evaluated for economic substance – was "the portion of the program that created the loss" (App. 113), *i.e.*, the Deerhurst GP transaction. The court's threshold inquiry regarding the proper scope of its economic substance analysis should have ended there.

Instead of recognizing the logical implications of its introductory paragraph, the District Court inexplicably veered off in another direction (App. 114):

> The threshold issue, therefore, is whether … the "transaction" includes only the portions of the Deerhurst Program occurring in 2000 … or … also includes the reinvestment of the Deerhurst GP liquidation proceeds into

> Deerhurst LLC and the trading occurring from 2001 onward.
> …

To our knowledge, no other court that has recognized the principle for which the District Court cited *James* – that the transaction to be evaluated for economic substance is the one that gave rise to the claimed tax benefit – has posited that "the transaction that gave rise to the claimed tax benefit" is not limited to the specific, objectively identifiable transaction that gave rise to the claimed tax benefit. The court's internal inconsistency is plain to see: by the end of its ensuing discussion, it had redefined its self-described task of "determin[ing] whether the portion of the [Deerhurst] program that created the loss is bona fide" (App. 113) to "determining whether the loss-generating portion of Sala's participation in Deerhurst was *part of* a bona fide transaction" (App. 120 [emphasis added]). That simply is not the appropriate inquiry under this Court's decision in *James* and under the case law of other Circuits. *See Coltec*, 454 F.3d at 1356-57; *Black & Decker*, 436 F.3d at 441; *Nicole Rose Corp.*, 320 F.3d at 284; *ACM*, 157 F.3d at 260.

3. Whatever nexus there may have been – perceived or otherwise – between the loss-generating Deerhurst GP transaction and the tax-neutral Deerhurst LLC investment program is irrelevant

In concluding (erroneously) that the 2000 Deerhurst GP transaction and the post-2000 Deerhurst LLC investment program comprised a single "transaction" that gave rise to taxpayers' artificial $60 million loss, the District Court found it particularly relevant that participants in the Deerhurst GP transaction (1) were ostensibly obligated to commit to the 5-year Deerhurst LLC program if there were profits at the end of 2000 and, in any event, (2) purportedly viewed the shelter and the investment program as a single undertaking. (App. 114-116.) But even if those observations are accurate, they simply are not pertinent to the proper application of the economic substance doctrine in this case.

If a promoter of an abusive tax shelter somehow ties participation in the shelter to investment of a specified amount of funds in a legitimate investment program also being marketed by the promoter, the economic substance of the investment program does nothing to imbue the abusive tax shelter – a discrete transaction – with economic substance. This is especially true in the instant case, where there is no indication in the record that Sala was required to participate in the abusive, tax-motivated Deerhurst GP transaction in order to participate in the legitimate, 5-year Deerhurst LLC trading program. The District Court clearly lost sight of this point in relying on Sala's conditional obligation to participate in the Deerhurst LLC investment program beginning in 2001, following the completion of the Deerhurst GP transaction in 2000, to justify its decision to treat the Deerhurst GP transaction and the Deerhurst LLC trading program as integrated components of a single transaction for purposes of its economic substance analysis.[13] (App. 115-116.) The relevant inquiry under this Court's decision in *James*, as well as under *Coltec*, *Black & Decker*, *Nicole Rose Corp*., *ACM*, and similar decisions, is whether the Deerhurst GP transaction – the transaction that indisputably was the

[13] Sala's obligation to participate in the Deerhurst LLC program was to terminate in the event he failed to receive a satisfactory tax opinion letter regarding his Deerhurst GP transaction by March 8, 2001, or if the IRS disallowed the claimed loss arising from the Deerhurst GP transaction. (App. 439-441.) These two tax-based escape provisions demonstrate in themselves that the Deerhurst GP transaction was a separate and discrete transaction from the Deerhurst LLC trading program.

sole source of taxpayers' claimed $60 million loss – had economic substance, not whether Sala's commitment, at the time he agreed to the Deerhurst GP transaction, to also participate in the Deerhurst LLC program beginning the following year established some kind of nexus between the tax shelter and the investment program.

That the shelter participants may have subjectively viewed the Deerhurst GP transaction and the Deerhurst LLC investment program as a single, integrated "transaction" (App. 114-116) is similarly beside the point. Indeed, deference to the subjective views of shelter participants regarding the parameters of the loss-generating transaction for tax purposes would eviscerate the economic substance doctrine by allowing promoters to legitimize any tax shelter by association. That is, promoters would be able to infuse any tax shelter with business purpose and sufficient potential economic profitability simply by attaching it to a legitimate transaction or investment program and then imparting to the participants the importance of viewing the two undertakings holistically.

The record in this case, as demonstrated above, leaves no doubt that the Deerhurst GP transaction was a discrete, pre-planned transaction that began in late November 2000 and ended approximately four weeks later. Indeed, completion of all the pre-planned steps comprising the Deerhurst GP transaction before the end of the year 2000 was an absolute requirement for the generation of the phony $60 million loss that was the sole purpose of that transaction. This being the case, it was reversible error for the District Court to fail to analyze the economic substance of the Deerhurst GP transaction in and of itself. As discussed in detail below, had the court limited its economic substance analysis to the specific transaction giving rise to the loss at issue – the Deerhurst GP transaction – as it was required to do under *James*, instead of lumping it together with the Deerhurst LLC trading program (and then relying heavily on the long-term aspect of that trading program to support its conclusion that taxpayers were entitled to the $60 million loss they claimed), it would have been constrained to conclude that the transaction producing taxpayers' claimed loss was devoid of economic substance.

4. The District Court's attempt to distinguish *James* and similar cases is unavailing

In attempting to distinguish this case from *James* and similar economic substance cases – cases that stand for the principle that the transaction to be evaluated for economic substance is the specific transaction that generated the claimed tax benefit – the District Court was content to point out factual differences without explaining why, in its view, those differences render the underlying legal principle inapplicable. We examine *James* and one other case – *Klamath Strategic Inv. Fund v. United States*, 472 F. Supp. 2d 885 (E.D. Tex. 2007), *appeal pending*, 5th Cir. No. 07-40861, also involving a Notice 2000-44 transaction – below.

a. *James v. Commissioner*

In *James*, the principal officers of a group of equipment-leasing corporations claimed that their own joint ventures, and not the corporations, were the owner-lessors of the leased equipment. This Court first rejected the taxpayers' argument that the corporations had undertaken the legitimate purchase-and-lease transactions as the agent of the joint ventures. 899 F.2d at 909. The Court then rejected the taxpayers' argument that purported sales of the equipment by the corporations to the joint ventures had economic substance by dint of the legitimate purchase-and-lease transactions:

> The only transactions at issue in this case are the purported sales by the [corporations] to the joint ventures. These sales cannot be legitimized merely because they were on the periphery of some legitimate transactions. [*Id*. at 910.]

Instead of expressly stating why, in its view, *James* is not controlling here, the District Court simply endeavored to summarize the opinion. (App. 116-117.) In so doing, the court conflated the *James* court's rejection of the taxpayers' "unitary transaction" and agency arguments. This led to the erroneous assertion that, in refusing to combine the suspect transactions and the legitimate transactions for economic substance purposes, "[t]he [*James*] court relied on the fact that the legitimate transactions were undertaken by entities independent from those claiming the tax loss." (App. 116.) This implied distinction between *James* and our case is inaccurate in two respects. First, the *James* court relied on no such "fact" in rejecting the "unitary transaction" argument. Second, and more importantly, no such fact can be gleaned from *James*; the only possible sense in which the leasing corporations could be considered "independent from" the joint ventures formed by their principal officers is that they were not acting as the agent of the joint ventures. *See id*. at 909.[14] Thus, the court's attempt to distinguish *James* is not well-founded.

b. *Klamath Strategic Inv. Fund v. United States*

Klamath, like this case, involved an attempt to legitimize a Notice 2000-44 tax shelter – this one premised on partnership assumptions of purported seven-year "premium" loans – by casting the basis-inflating loan transactions as part and parcel of a seven-year foreign exchange investment program. The taxpayers withdrew from the investment partnerships – as the promoters and the "lender" had intended all along – after 60 days, at which point the partnerships repaid the loans and made the liquidating distributions necessary to generate the claimed

[14] If, in referring (App. 116) to the *James* court's observation that "there were many individual actors and many individual transactions" in that case, 899 F.2d at 910, the District Court intended to suggest a material distinction on that basis, the suggestion is without merit. Apart from the fact that this case, too, involves many individual actors (including unrelated counterparties) and many individual investment transactions, *James* stands for the proposition that tax-driven transactions must stand or fall on their own, whether packaged with hundreds of legitimate transactions or just one.

tax losses. The *Klamath* court expressly limited its economic substance analysis to the loan transactions. 472 F. Supp. 2d at 895.

The District Court attempted to distinguish *Klamath* on the ground that, "[u]nlike the phony seven-year plan in *Klamath*, … not only the investors, but also the promoters and managers of the Deerhurst Program, intended the program to be long term." (App. 118.) The *Klamath* court, however, limited its economic substance analysis to the loan transactions there because they were the transactions that gave rise to the claimed tax benefits, not because the purported seven-year term of the investment program was "phony":

> When applying the economic substance doctrine, courts emphasize that the transaction to be analyzed is the particular transaction that gives rise to the tax benefit, and not collateral transactions which do not produce tax benefits. [Citations to *Coltec*, *Nicole Rose Corp*., and *ACM*.] In the present case, the transactions that provide the cornerstone for the tax benefits are the loan agreements with NatWest.
> …

472 F. Supp. 2d at 895. Thus, the distinction drawn by the District Court between the tax-neutral investment programs in *Klamath* and this case is simply not relevant. It follows that the court's observations in support of its finding that the legitimate investment program in this

case (the Deerhurst LLC program) was intended to be long-term (App. 118), even if they are accurate, are likewise irrelevant.

5. The District Court's reliance on the Tax Court's memorandum opinion in *Salina* is misplaced

Having found this case "unlike those cited by the Government" (App. 118), the District Court instead "[found] the facts here akin to those in" *Salina P'ship LP v. Commissioner*, 80 T.C.M. (CCH) 686 (2000). (App. 119.) In *Salina*, the Tax Court rejected the Commissioner's argument that the year-end tax device there should be evaluated for economic substance apart from a follow-on, legitimate investment program. Because the Commissioner ultimately prevailed on other grounds, that aspect of *Salina* was never subject to appellate scrutiny.

In relying on *Salina*, the District Court erroneously suggested that, in deciding the threshold issue regarding the proper scope of the economic substance inquiry,

> [t]he [*Salina*] court was persuaded by the fact that the taxpayer – like Sala here … – conducted significant due diligence on the 1993 forward program before investing in the 1992 program and that a condition of investment in the 1992 program – like the investment in Deerhurst GP here –

> was the requirement that the liquidated 1992 funds be reinvested in the 1993 program. …

(App. 119.) To the contrary, the *Salina* court made those observations in support of its conclusion that the transaction – as previously identified to include both the tax device and the ensuing legitimate investment program – had a valid business purpose. *See* 80 T.C.M. (CCH) at 695. The *Salina* court's discussion of the antecedent issue did not extend beyond its comment that "[s]egregating FPL's investment in Salina into two parts … would violate the principle that the economic substance of a transaction turns on a review of the entire transaction."[15] *Ibid*.

Given the paucity of analysis of this issue in *Salina*, the case provides minimal support for the District Court's decision to evaluate

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[15] The two cases cited by the Tax Court in support of that statement, *Kirchman v. Commissioner*, 862 F.2d 1486 (11th Cir. 1989), and *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254 (1999), do not offer much more insight. *Kirchman* stands for the unremarkable proposition that, in the case of straddles, *see* I.R.C. § 1092(c), the transaction to be evaluated for economic substance consists of both "legs" of the straddle. 862 F.2d at 1493-94. And the court in *Winn-Dixie*, citing *Kirchman*, merely resolved to "focus on the [corporate-owned life insurance] transaction in its entirety rather than any single step." 113 T.C. at 280.

the entire Deerhurst Program, rather than the discrete Deerhurst GP transaction, for economic substance. Indeed, aside from the District Court, no court (including the Tax Court) has ever cited, let alone relied upon, this aspect of *Salina*. To the extent the decision in *Salina,* a memorandum decision that has no precedential effect in the Tax Court,[16] may be construed as supporting the District Court's decision in this case, we submit that it was wrongly decided and contrary to this Court's decision in *James* and to similar decisions of other Courts of Appeals, including *Coltec*, *Black & Decker*, *Nicole Rose Corp*., and *ACM*.

In any event, the general principle cited by the *Salina* court – that the economic substance of a transaction turns on a review of the entire transaction – is entirely compatible with the general principle *not* discussed by the *Salina* court – that the *transaction* to be analyzed for economic substance is the specific one that gave rise to the claimed tax benefit. For instance, although the Third Circuit in *ACM* correctly recognized that the transactions to be evaluated for economic substance were those that gave rise to the claimed tax benefit, 157 F.3d at 260 &

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[16] *See, e.g., Huffman v. Commissioner*, 126 T.C. 322, 350 (2006), *aff'd*, 518 F.3d 357 (6th Cir. 2008).

n.57, it also affirmed the general principle of viewing transactions as a whole, *id*. at 247. In the instant case, the transaction giving rise to taxpayers' claimed $60 million loss – and therefore the transaction that must be viewed as a whole – was the Deerhurst GP transaction, a self-contained transaction that was discrete from the Deerhurst LLC trading program that the District Court erroneously included in its economic substance analysis.

In short, the District Court erred as a matter of law in evaluating the entire so-called Deerhurst Program, rather than the Deerhurst GP transaction, for economic substance.

C. The Deerhurst GP transaction clearly lacked economic substance

1. There was no realistic expectation of economic gain from the Deerhurst GP transaction

One of the principal means for evaluating the economic substance of a transaction is to ascertain whether, at the time the taxpayer entered into the transaction, there was a reasonable possibility that the transaction would generate an economic profit for the taxpayer. *See, e.g.*, *Jade Trading*, 80 Fed. Cl. at 48 (collecting cases to that effect). The parties' experts agreed that the maximum gross profit that the tax trades could have generated (before fees) was approximately $550,000. (App. 437, 502, 512.) Taxpayers' own expert, however, acknowledged that the possibility of achieving that maximum gross profit was "very unlikely." (App. 436.) That the five four-sided spreads (which accounted for approximately $535,000 of the $550,000 maximum gross profit (App. 437, 502)) would only be in existence for 2-3 weeks of their one-year term reduced this possibility even further. Thus, it is important to recognize at the outset that the $550,000 "starting point" for evaluating the potential profitability of the Deerhurst GP transaction is almost entirely theoretical.[17] With that in mind, we turn to the subject of fees and costs.

[17] The Government's expert did not, as the District Court mistakenly stated (App. 127-128), posit that the possibility of the tax trades achieving maximum profitability over their one-year term was as high as 50 percent. Rather, Dr. DeRosa surmised that the possibility that *any particular four-sided spread* would achieve its maximum profitability was as high as 50 percent. (App. 514.) As Dr. DeRosa explained, the possibility of achieving the *aggregate* maximum profitability of $550,000 was significantly lower because the movements of the various currencies in relation to one another that would have to occur were highly improbable. (App. 514-515.)

Starting from the theoretically maximum gross profit of $550,000, the District Court determined that, taking into account Krieger's fees,[18] as well as "mark-up" fees to which Krieger's company, BTC, was entitled, the maximum net profit that the tax trades could have generated was approximately $330,000. (App. 127-128.) That figure, however, is vastly overstated in at least two respects. Indeed, as demonstrated below, when the mark-up fees with respect to the tax trades are correctly calculated, and the costs Sala incurred relating to his participation in the Deerhurst GP transaction ("transaction costs") are taken into account, it becomes apparent that Sala could not possibly have had an expectation of realizing any economic gain from his participation in the Deerhurst GP transaction. This confirms that the Deerhurst GP transaction was an economic sham of the same ilk as the straddle transactions invalidated by this Court in *Keeler*.

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[18] Sala agreed to pay a so-called "incentive fee" equal to 30% of the gross profit from his trades plus a management fee equal to 1% of the notional size of the account (or 4% of the actual size of the account, assuming the account was traded at 4:1 "leverage," as advertised). (App. 127.)

First, the District Court clearly erred in its calculation of the mark-up fees owed to BTC with respect to the tax trades. The court erred by calculating these fees – equal to 1.5 "pips" or $150 per $1 million traded – on the basis of the *premiums paid for the purchased options* (rounded by the court to $60 million) rather than on the basis of the face amount of both the purchased options and the sold options (which translated to approximately $3.4 *billion*). (App. 127, 565-566.) The court therefore calculated a mark-up fee of $9,000 with respect to the tax trades, whereas Dr. DeRosa's uncontradicted expert testimony established that the correct figure is approximately $500,000. (*Ibid.*) Thus, the mark-up fees that Sala agreed to pay BTC were far greater than the maximum net profit the court determined he could have realized from the tax trades.[19]

[19] It is of no moment that, sometime after Sala agreed to participate in the Deerhurst GP transaction, BTC apparently decided to waive the $500,000 that it was due. The critical fact is that the amount of fees that Sala agreed to pay at the time he decided to participate in the Deerhurst GP transaction far exceeded the maximum potential economic gain he could have realized from the tax trades, thereby establishing that Sala was motivated exclusively by the promised tax benefits and not by any business purpose.

Second, the District Court erroneously failed to account for Sala's transaction costs. At the very least, those costs include the entire $75,000 he paid for his tax opinion letter. *See, e.g., Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 175-77 (D. Conn. 2004), *aff'd on other grounds by unpublished order*, 96 A.F.T.R. 2d (RIA) 6433 (2d Cir. 2005); *see also Stobie Creek*, 82 Fed. Cl. at 694 & n.52; *Jade Trading,* 80 Fed. Cl. at 14 & n.3, 49-50. They also include a substantial portion of the $25,000 he paid to KPMG, as well as additional legal fees incurred in connection with his participation in the shelter. (App. 550.) *See Long Term Capital*, 330 F. Supp. 2d at 177 n.73 ("[T]he legally material consideration is … the decision to incur costs to plan and accomplish a transaction.").

In sum, given the unlikelihood that the tax trades would achieve their maximum gross profitability (let alone achieve it in 2-3 weeks), the enormous mark-up fees with respect to those trades, and Sala's substantial transaction costs, the realistic chances that the Deerhurst GP transaction would generate any economic gain for him were reduced to nil. *See Keeler*, 243 F.3d at 1218.

2. In any event, any conceivable profit from the Deerhurst GP transaction would be so negligible as to preclude a finding of economic substance

This Court made clear in *Keeler* that the mere possibility that the transaction in question could produce some economic profit for the taxpayer does not foreclose a finding of no economic substance. *See* 243 F.3d at 1219; *see also Rogers*, 281 F.3d at 1116 n.4 (the economic substance doctrine "allows the IRS to deny tax benefits if the economic substance of a transaction is insignificant relative to the tax benefits obtained"); *ACM*, 157 F.3d at 258 (same). In *Keeler*, the taxpayer sought to deduct artificial losses resulting from commodity straddle transactions. In upholding the Tax Court's determination that the transactions were economic shams, notwithstanding that the transactions had the possibility of producing some economic profit for the taxpayer, this Court relied on several factors, including that the profit potential from the straddles was anemic in comparison to the amount of the tax losses the straddles were designed to produce, that the taxpayer appeared to have been motivated exclusively by the tax losses he expected to receive, and that the manner in which the transactions were executed, coupled with the large transaction fees, reduced to almost nil the realistic expectation of economic gain. *See* 243 F.3d at 1214, 1217-18.

The Deerhurst GP transaction is an economic sham for essentially the same reasons this Court determined that the straddle transactions in *Keeler* were economic shams. The amount of economic profit that even theoretically could have been generated by the Deerhurst GP transaction was minuscule in comparison to the promised tax savings of $23 million. Moreover, the large fees associated with the tax trades, together with Sala's significant transaction costs, reduced the realistic expectation of economic gain to almost nothing (or eliminated it altogether) and demonstrated that Sala was motivated exclusively by the enormous tax benefits he expected to receive. *Jade Trading*, which involved essentially the same tax avoidance scheme as that embodied in the Deerhurst GP transaction, is also instructive in this regard. The *Jade* court determined that the transaction there was an economic sham because the maximum gross profit the taxpayer could have realized was insignificant in comparison to the tax benefits the taxpayer expected to receive, and because the large transaction fees that the taxpayer had agreed to pay eliminated any realistic possibility that the taxpayer would realize any net economic gain. *See* 80 Fed. Cl. at 49-50. The instant case presents the same situation.

3. The Deerhurst GP transaction had no tax-independent business purpose

The linchpin in the proof that the Deerhurst GP transaction was nothing but a tax avoidance scheme devoid of any legitimate business purpose or objective is that it was pre-determined that Sala's offsetting currency positions would be terminated by the close of the year 2000, without regard to market conditions, in order to produce the $60 million loss that was the *raison d'être* for the entire scheme. Sala admitted in his testimony that he understood that his currency positions would be liquidated before the end of 2000 to generate the $60 million loss he was seeking (App. 547, 548-549), and the District Court found that Sala's Deerhurst GP account "was intended from inception to be liquidated at the end of 2000." (App. 330.) That Sala had agreed in advance to the liquidation of his offsetting currency positions by the close of the year 2000 (only a few weeks after he established those positions), even if such liquidation would have the effect of locking in his maximum loss of $716,860, is virtually conclusive evidence that the Deerhurst GP transaction was wholly devoid of any business purpose. *See Keeler*, 243 F.3d at 1218; *Miller v. Commissioner*, 836 F.2d 1274, 1276-77 (10th Cir. 1988).[20]

Moreover, that the entire concept of the "test period" was a ruse is self-evident. Simply put, no rational investor would condition a five-year commitment of millions of dollars of his capital on the prospective investment manager's ability to generate as little as one penny of trading profits during a year-end "test period." Indeed, taxpayers' own expert testified that he was "surprised" by this aspect of the arrangement: "I took it that he [Sala] was pretty much committed to going in in general from the outset, so that probably was not going to be of paramount importance to him." (App. 562-563.) That suspicion is borne out by the fact that Sala executed his subscription agreement

[20] In his deposition testimony, Krieger indicated that there were business reasons for closing out the offsetting currency positions at the close of the year 2000. (App. 434.) In his post-trial declaration, however, Krieger admitted that his deposition testimony in this regard was false, that there was no sound business reason to liquidate the tax trades by the close of the year, and that the promoter of the Deerhurst GP transaction, Michael Schwartz, had explained to him that the trading accounts were required to be liquidated by the end of the year to generate the tax losses that the transaction was structured to achieve. (App. 214.)

with respect to Deerhurst LLC before the test period even started. (App. 108-109, 389.)

In short, the District Court looked through the wrong end of the telescope, so to speak, in analyzing the validity of the $60 million tax loss claimed by taxpayers in this case. By wrongly concluding that the "transaction" that generated taxpayers' phony $60 million loss in 2000 included the 5-year, post-2000 Deerhurst LLC trading program, the court wrongly held that taxpayers' $60 million loss – generated *solely* by the 2000 Deerhurst GP tax shelter – was legitimate. It manifestly was not, and the court's decision to the contrary must be reversed.

II

Taxpayers' fictitious $60 million loss does not meet the requirements for deductibility under I.R.C. § 165, without regard to the economic substance of the Deerhurst GP transaction

Standard of review

The issues under I.R.C. § 165 – whether the District Court erroneously identified the transaction to be analyzed for profit motive under § 165(c)(2), and whether taxpayers' non-economic loss was "sustained" within the meaning of § 165(a) – are questions of law that this Court reviews *de novo*.

Issues Raised and Ruled On

The Government raised the § 165(c)(2) issue in its Proposed Findings. (App. 91.) The District Court ruled on this issue in its Opinion. (App. 136-141.) The Government indirectly raised the § 165(a) issue in its Proposed Findings (App. 90) and directly raised it in its opening statement at trial. (App. 533-534.) The District Court did not rule on the § 165(a) issue.

A. Introduction

The deductibility of losses is governed by I.R.C. § 165. Two important aspects of § 165 serve as a backstop to the economic substance doctrine, particularly as applied to individuals. First, as is relevant here, § 165(c)(2) limits the deductibility of an individual's losses to those incurred in transactions entered into for profit. As the District Court correctly recognized (App. 129, 137), the term "for profit" in § 165(c)(2) means "primarily for profit." *Miller*, 836 F.2d at 1278. Second, § 165(a) requires that a loss be "sustained" during the taxable year in order to be deductible. As discussed below, longstanding regulations and case law interpreting this requirement establish that only bona fide, economic losses are deductible under § 165.[21]

B. The District Court erred in evaluating Sala's profit motive by reference to the entire Deerhurst Program rather than by reference to the Deerhurst GP transaction

Just as the transaction to be evaluated for economic substance is the one that gave rise to the claimed tax benefit, so, too, the transaction to be evaluated for profit motive under § 165(c)(2) is the one that gave rise to the claimed loss. This Court applied this principle in *Keeler*, where it refused to impute a primary profit motive to loss-generating straddle transactions based on other, legitimate investment transactions entered into by the taxpayer: "Even if we were convinced that the [tax-motivated] trades were part of taxpayer's overall profit-motivated investment strategy, the transactions themselves would have to be profit-motivated in order to be deductible under § 165(c)." 243 F.3d at 1220. Similarly, even if the Deerhurst GP transaction can be viewed as being "part of" the overall Deerhurst Program in some sense,

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[21] *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), which taxpayers were quick to cite below, is not to the contrary, as the applicability of § 165 was not at issue in that case.

that association is irrelevant to the § 165(c)(2) inquiry (just as it is irrelevant to the economic substance inquiry), since the Deerhurst GP transaction itself would have to have been primarily profit-motivated to render the claimed $60 million loss generated by that transaction deductible under § 165. *See ibid.*

In light of the foregoing, the District Court's conclusion (App. 141) that "Sala entered into the Deerhurst Program with a good faith belief that the venture would create a benefit in excess of the anticipated tax loss" – as questionable as that conclusion may be – is utterly beside the point, as is its entire discussion (App. 136-141) in support of that conclusion. Rather, the proper inquiry is whether Sala participated in the loss-generating Deerhurst GP transaction for the primary purpose of earning an economic profit. The answer is plainly "no"; Sala obviously was instead motivated primarily, if not exclusively, by the $60 million in artificial tax losses he expected to receive from the Deerhurst GP transaction. The expected $60 million loss was intended to shelter from tax the $60 million in income that Sala realized in 2000, producing a reduction in his tax liability of approximately $23 million. (App. 546.) On the other hand, the maximum gross profit (before fees and transaction costs) Sala could have realized from the tax trades was only $550,000, and that highly theoretical figure is drastically reduced anyway, if not eliminated altogether, by fees and transaction costs. See pp. 46-50, *supra*.

It thus cannot be seriously contended that Sala's primary motivation for the Deerhurst GP transaction was the slim possibility that he might realize a nominal net profit, rather than the $23 million in tax savings that he was promised and expected to receive. Indeed, Sala's admitted understanding (App. 547, 548-549) that, to achieve his $23 million in tax savings, his offsetting currency positions would be closed out before the end of the year 2000, regardless whether such termination of his positions would be economically disadvantageous to him, demonstrates that the possibility (if any) of realizing a very modest profit from his currency positions not only was not his primary motivation for participating in the Deerhurst GP transaction, but, in fact, played no part whatsoever in his decision to participate in that transaction. *See Keeler*, 243 F.3d at 1218; *Miller*, 836 F.2d at 1277.[22]

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[22] Since participation in the Deerhurst GP transaction was not a

(continued...)

C. In any event, Sala's claimed $60 million loss is not a bona fide loss within the meaning of I.R.C. § 165 and the regulations thereunder and for that reason alone is not deductible

I.R.C. § 165(a) sets forth the general rule that a deduction is allowable for losses sustained during the taxable year. The Treasury Regulations issued under § 165 provide that, to be allowable as a deduction, the loss must be *actually* sustained during the taxable year. "Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss." Treas. Reg. § 1.165-1(b). The economic reality requirement embodied in the limitation of the deduction of losses to only "bona fide" losses has long been part of the case law. The classic judicial expression of this aspect of § 165(a) dates from 1935:

> To secure a deduction, the statute requires that an actual loss be sustained. An actual loss is not sustained unless when the entire transaction is concluded the taxpayer is poorer to the extent of the loss claimed; in other words, he has that much less than before.

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[22](...continued) prerequisite for subscribing to the Deerhurst LLC trading program, any profit motive Sala may have had for participating in the trading program cannot be imputed to his participation in the Deerhurst GP transaction.

Shoenberg v. Commissioner, 77 F.2d 446, 449 (8th Cir. 1935) (applying § 23(e) of the Revenue Act of 1928).

A more recent judicial affirmation of this aspect of § 165(a) may be found in *ACM*, 157 F.3d at 251-52. Although the Third Circuit devoted most of its opinion to the economic substance doctrine, it also recognized the role of § 165(a) in this context. Referencing Treas. Reg. § 1.165-1(b), the Court of Appeals observed that "[t]ax losses such as these, which are purely an artifact of tax accounting methods and which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations." 157 F.3d at 252; *see Kornman & Assocs., Inc. v. United States*, 527 F.3d 443, 456 n.11 (5th Cir. 2008) (quoting this language with approval); *H.J. Heinz Co. & Subs. v. United States*, 76 Fed. Cl. 570, 592 n.38 (2007), *appeal pending*, Fed. Cir. No. 07-5146; *see also Friedman v. Commissioner*, 869 F.2d 785, 791-93 (4th Cir. 1989); *Long Term Capital,* 330 F. Supp. 2d at 171.

This Court also has recognized the principle that only bona fide, economic losses are deductible under § 165. In *Keeler*, 243 F.3d 1212, the Court disallowed claimed losses from straddle transactions under both the economic substance doctrine and § 165(c)(2). In the process, the Court made the following observation:

> Economically, taxpayer's recognized losses … were not losses at all because of their offsetting gain legs; they were taxed as losses due only to the necessary but artificial device of separate taxable years. Deduction of several million dollars in losses distorted taxpayer's economic results and violated the principle that tax advantages must be linked to actual losses. …

Id. at 1218. This language is very similar to the following passage from *ACM*:

> In order to be deductible, a loss must reflect actual economic consequences sustained in an economically substantive transaction and cannot result solely from the application of a tax accounting rule to bifurcate a loss component of a transaction from its offsetting gain component to generate an artificial loss … . [157 F.3d at 252.]

In the instant case, it is undisputed that Sala's claimed $60 million loss from the Deerhurst GP transaction was solely a paper loss that was devoid of any economic content. Sala confirmed this fact himself when he testified that he realized a net profit in the $60,000 range from the Deerhurst GP transaction (App. 541), but, nevertheless, claimed on his 2000 tax return that he had realized a $60 million loss from that transaction (App. 340, 343-344).[23] The District Court in its opinion never addressed how Sala was entitled to deduct his fictitious $60 million loss under I.R.C. § 165 as a bona fide loss actually sustained during the taxable year. As this Court's decision in *Keeler* and the other authorities cited above make clear, Sala's claimed loss was not a bona fide loss within the meaning of I.R.C. § 165 and, for that reason alone, it was reversible error for the District Court to uphold Sala's deduction of that loss.

III

Taxpayers' fictitious $60 million loss is eliminated by Treas. Reg. § 1.752-6

Standard of review

The validity of Treas. Reg. § 1.752-6 is a question of law that this Court reviews *de novo*.

[23] Sala's asserted profit of $60,000 ignores, *inter alia*, the $75,000 fee he paid for his tax opinion letter regarding the Deerhurst GP transaction.

Issue Raised and Ruled On

The Government raised the applicability of Treas. Reg. § 1.752-6 in its Proposed Findings. (App. 92.) The District Court ruled on this issue in its Opinion. (App. 149-161.)

A. Treas. Reg. § 1.752-6 and Its Genesis

1. Overview

Treas. Reg. § 1.752-6 contains a retroactive basis-reduction rule which, if valid, would have the effect of reducing Solid's basis in its Deerhurst GP interest by the amount of the premiums associated with the short options included in the tax trades: $60,259,569. This reduction in basis would serve, in turn, to wholly eliminate the fictitious $60 million loss claimed by taxpayers on their 2000 return.

The IRS promulgated § 1.752-6 in response to the directive in § 309(c)(1) of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763A-587, 638 (2000) (the "Act" or "2000 Act"). *See* T.D. 9062, 2003-2 C.B. 46, 47. The District Court, however, held that § 1.752-6 exceeds the authority granted in Act § 309(c)(1) and, moreover, was otherwise invalid. (App. 149-161.) In so holding, the court declined to follow the contrary decision of the Seventh Circuit in

Cemco Investors, LLC v. United States, 515 F.3d 749 (7th Cir. 2008), *cert. denied*, 129 S. Ct. 131 (2008). In *Cemco*, which involved a similar version of the abusive basis-inflating scheme at issue here, the Court of Appeals held that the Treasury Department had validly issued § 1.752-6 pursuant to Act § 309(c)(1) and that, therefore, the regulation was dispositive of the wholly artificial tax loss claimed by the taxpayer in that case. In the process, the Seventh Circuit expressly rejected the contrary decision of the district court in *Klamath*, 472 F. Supp. 2d 885, on which the District Court here relied heavily in concluding that § 1.752-6 is invalid. (App. 155, 157.)

2. General Basis Rules for Shareholders and Partners

Before discussing in detail the errors made by the District Court in invalidating Treas. Reg. § 1.752-6, a brief discussion of the basis rules pertaining to shareholders and partners is in order.

When a taxpayer contributes property to a corporation as part of a specified tax-free exchange, his basis in the shares received in the exchange equals his former basis in the contributed property, with certain adjustments. I.R.C. § 358(a)(1). Under one of these adjustments, the taxpayer's basis in the shares received is decreased by the amount of any cash he received in the exchange. I.R.C. § 358(a)(1)(A)(ii). For these purposes, if the corporation assumes a liability of the taxpayer as part of the exchange, the taxpayer generally is treated as having received cash in the exchange equal to the amount of the assumed liability. I.R.C. § 358(d)(1).

The rules for partnerships are similar, except that a partner's basis in his partnership interest ("outside" basis) includes not only his former basis in property contributed to the partnership, *see* I.R.C. § 722, but also his share of partnership liabilities, determined in accordance with regulations under § 752. Thus, when a partnership assumes a liability of a partner, the resulting deemed distribution of cash that reduces the partner's outside basis, *see* I.R.C. §§ 752(b), 733(1), is accompanied by a (basis-increasing) deemed contribution of cash equal to the partner's share of the partnership liability resulting from such assumption. *See* I.R.C. §§ 752(a), 722; *see also* Treas. Reg. § 1.752-1(f). Parity with the shareholder basis rules is restored upon the subsequent extinguishment of the assumed liability (or upon the partner's withdrawal from the partnership, if earlier). *See* I.R.C. §§ 752(b) (treating any decrease in a partner's share of partnership liabilities as a basis-decreasing distribution of cash), 733(1), 732(b). Under § 732(b), the basis of property distributed in liquidation equals the partner's outside basis, reduced by any cash distributed.

3. Congressional Concern with Certain Liability Assumptions

In August 1999, Congress passed legislation that included a provision broadening the scope of I.R.C. § 357(b), the anti-abuse rule with respect to assumptions of liabilities in connection with certain tax-free transfers to controlled corporations. *See* H.R. 2488, 106th Cong. § 1512 (1999). Congress was concerned with the situation where, in connection with a transfer of full-basis property (*i.e.*, basis equals value) to a corporation in exchange for stock and the corporation's assumption of a virtually offsetting liability of the transferor, the transferor was taking the position that the liability assumption rule of § 358(d)(1) did not effect a corresponding reduction in his basis in the shares received.[24]

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[24] This might have been the case where the liability was either contingent in some manner or was arguably subject to the exception of § 358(d)(2) as a "liability excluded under" § 357(c)(3) (relating to certain liabilities that would give rise to a deduction upon payment). *See Coltec*

(continued...)

See S. Rep. No. 106-120, at 214-15 (1999). In this manner, the transferor could claim a basis in the stock far in excess of its value, paving the way for an artificial tax loss. The conference report accompanying the legislation provided:

> It is also expected that the Treasury Department will promptly examine the use of partnerships and apply similar rules (for example, with respect to adjustments to the basis of a partnership interest with respect to certain contingent liabilities) where there is a principal purpose of avoiding Federal income tax through the use of a transaction that includes the assumption of liabilities by a partnership. The conferees note that pursuant to section 7805(b)(3), if necessary to prevent abuse, the Secretary could determine that any regulations applying such rules should be effective on the same date as this provision, i.e., July 15, 1999. [H.R. Conf. Rep. No. 106-289, at 538 (1999).]

Although the President vetoed H.R. 2488 (of which section 1512 was but a tiny part), the Senate passed another bill approximately one month later containing a provision that would have amended I.R.C. § 358 in substantially the same manner that Act § 309 eventually did. *See* S. 1792, 106th Cong. § 213 (1999). Like Act § 309, this provision

[24](...continued)
Indus., Inc. v. United States, 454 F.3d 1340, 1347-51 (Fed. Cir. 2006) (discussing § 358 as in effect prior to the 2000 Act); S. Rep. No. 106-120, at 214-15 (1999) (positing, by way of example, a liability that is both contingent *and* deductible upon payment).

directed the IRS to prescribe comparable rules for "transactions involving partnerships" and authorized the retroactive application of those regulations to October 19, 1999. The committee report discussing § 213 of S. 1792 specifically refers to the conference report to H.R. 2488 (H.R. Conf. Rep. No. 106-289) cited above, as does the committee report discussing § 709 of H.R. 5542, 106th Cong. (2000), the provision eventually enacted as Act § 309. *See* S. Rep. No. 106-201, at 46, 47 (1999); H.R. Conf. Rep. No. 106-1004, at 368-69 (2000), *reprinted in* 2000-3 C.B. 390, 434-35.

4. Act § 309 and Treas. Reg. § 1.752-6

Act § 309(a) added subsection (h) to I.R.C. § 358. Section 358(h) provides in general that if, after application of the normal § 358 basis rules, the basis of stock received in certain tax-free exchanges exceeds its value, then the basis of the stock is reduced (but not below its value) by the amount of any liability assumed by the corporation as part of the exchange and not otherwise taken into account under § 358(d)(1). I.R.C. § 358(h)(1). The term "liability" is broadly defined to include any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for tax purposes.

I.R.C. § 358(h)(3). Exceptions apply (unless the Secretary provides otherwise) if the transfer to the corporation includes the trade or business, or substantially all of the assets, with which the liability is associated. I.R.C. § 358(h)(2).

Act § 309(c)(1) directed the IRS to provide for the application of comparable rules to partnerships. Specifically, Congress directed the IRS to –

> prescribe rules which provide appropriate adjustments under subchapter K of chapter 1 of the Internal Revenue Code of 1986[25] to prevent the acceleration or duplication of losses through the assumption of (or transfer of assets subject to) liabilities described in section 358(h)(3) of such Code (as added by subsection (a)) in transactions involving partnerships …

Act § 309(d)(2) authorizes the retroactive application of such rules to October 19, 1999.

The IRS issued Treas. Reg. § 1.752-6 in June 2003 and made the provision applicable to assumptions of liabilities occurring after October 18, 1999, and before June 24, 2003. Under the regulation, if a partnership assumed a contributing partner's liability (as defined in

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[25] Subchapter K (I.R.C. §§ 701-777) pertains to partners and partnerships.

§ 358(h)(3)) during the relevant time period and, after application of the normal § 752 basis rules, the basis of the partner's partnership interest exceeded its adjusted value, then the basis of the partnership interest is reduced (but not below its adjusted value) by the amount of any liability assumed by the partnership as part of the transaction and not otherwise taken into account under § 752(a) and (b). Treas. Reg. § 1.752-6(a). "Adjusted value" for these purposes is the value of the interest increased by the partner's share of partnership liabilities as determined under the normal § 752 rules. *Ibid*. The exceptions described in § 358(h)(2) apply here as well, except that the exception described in § 358(h)(2)(B) (where the assumption is accompanied by the transfer of substantially all of the assets associated with the liability) does not apply to transactions described in Notice 2000-44. Treas. Reg. § 1.752-6(b).

B. The District Court erroneously held, contrary to the Seventh Circuit's decision in *Cemco*, that Treas. Reg. § 1.752-6 is invalid

1. The *Cemco* Decision

In *Cemco*, the Seventh Circuit held that, in accordance with I.R.C. § 7805(b)(6), the retroactive effective date of Treas. Reg. § 1.752-6 is valid because the Secretary promulgated the regulation pursuant to the Congressional grant of authority set forth in Act § 309(c)(1). 515 F.3d at 752. The Court of Appeals reasoned that –

> although regulations generally do not apply to transactions that occur before the initial publication date of a draft regulation, see 26 U.S.C. § 7805(b)(1)(C), the norm of prospective application "may be superseded by a legislative grant from Congress authorizing the Secretary to prescribe the effective date with respect to any regulation." 26 U.S.C. § 7805(b)(6). Section 309 of the Community Renewal Tax Relief Act of 2000, Pub. L. 106-554, 114 Stat. 2763A-587, 638 (2000), enacts basis-reduction rules for many transactions and authorizes the IRS to adopt regulations prescribing similar rules for partnerships and S corporations. Section 309(d)(2) of the 2000 Act adds that these regulations may be retroactive to October 18, 1999. That's the power the Commissioner used when promulgating Treas. Reg. § 1.752-6.

Ibid. Moreover, the Court of Appeals expressly rejected the contrary holding of the district court in *Klamath*, upon which the court below relied heavily. *Ibid.* Specifically, the Court of Appeals was baffled by the *Klamath* court's conclusion (shared by the District Court here) that § 1.752-6 was not promulgated pursuant to Act § 309(c)(1), since the regulation clearly "applies to partnerships (and LLCs treated as partnerships) a rule 'similar' to the approach that Congress adopted for other business entities" in the 2000 legislation. *Ibid.* The Seventh

Circuit's decision in *Cemco* thus directly supports the Government's position here that the court below erred as a matter of law in holding that the Treasury Department's decision to make § 1.752-6 retroactive to October 19, 1999, was not authorized under I.R.C. § 7805(b)(6).[26]

2. The District Court failed to give proper deference to Treas. Reg. § 1.752-6

a. Judicial Deference to Agency Regulations

Where Congress expressly authorizes an agency to promulgate rules addressing a specific area of concern, the ensuing regulations "are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Chevron USA, Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843-44 (1984); *see Sullivan v. Zebley*, 493 U.S. 521, 528 (1990) (judicial review in this situation is "limited to

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[26] We note that in *Stobie Creek*, 82 Fed. Cl. 636, the Court of Federal Claims held that Treas. Reg. § 1.752-6 could not be applied retroactively, but then held that the basis-inflating scheme at issue there was an economic sham anyway. We submit that the decision in *Stobie Creek* regarding the validity of § 1.752-6 is wrong for the reasons set forth in this brief. Moreover, in the most recent decision involving § 1.752-6, the validity of the regulation was upheld. *Maguire Partners – Master Investments, LLC v. United States*, 2009 WL 279100, **18-20 (C.D. Cal. Feb. 4, 2009). The court there, agreeing with the Seventh Circuit's decision in *Cemco*, concluded that the *Stobie Creek* court erred in holding that § 1.752-6 could not be applied retroactively. *Id*. at *19.

determining whether the regulations promulgated exceeded the [agency's] statutory authority and whether they are arbitrary and capricious") (internal quotation marks omitted). Moreover, "when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law," and the agency issues rules under that general rulemaking authority, a reviewing court "is obliged to accept the agency's position if Congress has not previously spoken to the point at issue and the agency's interpretation is reasonable." *United States v. Mead Corp.*, 533 U.S. 218, 226-27, 229 (2001) (citing *Chevron*, 467 U.S. at 842-45). The degree of deference to be accorded administrative interpretations that do not qualify for *Chevron* deference (as explicated by *Mead*) will "vary with circumstances," depending on "the degree of the agency's care, its consistency, formality, and relative expertness, and to the persuasiveness of the agency's position." *Mead*, 533 U.S. at 228 (citing *Skidmore v. Swift & Co.*, 323 U.S. 134, 139-40 (1944) (fn. ref. omitted)).

b. Retroactive Tax Regulations

The IRS is generally prohibited from issuing retroactive regulations. I.R.C. § 7805(b)(1). This proscription, however, "may be superseded by a legislative grant from Congress authorizing the Secretary to prescribe the effective date with respect to any regulation." I.R.C. § 7805(b)(6). Moreover, "[t]he Secretary may provide that any regulation may take effect or apply retroactively to prevent abuse." I.R.C. § 7805(b)(3). Although no court has specifically addressed the standard of review applicable to the Commissioner's invocation of § 7805(b)(3), the Commissioner's general authority to issue retroactive regulations under pre-1996 law was subject to judicial review for abuse of discretion. *United States v. Irvine*, 511 U.S. 224, 229 n.6 (1994).

c. Application to § 1.752-6

The IRS cited Act § 309(c) as authority for the issuance of Treas. Reg. § 1.752-6. *See* T.D. 9062, 2003-2 C.B. 46, 47. In the case of such a "specific authority" regulation, the primary inquiry is whether the regulation falls within the statutory delegation of authority. *Rowan Cos., Inc. v. United States*, 452 U.S. 247, 253 (1981). Here, the threshold issue is whether the directive in Act § 309(c)(1) encompasses a regulation dealing with transactions involving assumptions of liabilities by partnerships (the domain of § 752). If it does, then the inquiry shifts to whether, under *Chevron*, the IRS's issuance of this particular regulation was a valid exercise of that authority. If it was, then the regulation's retroactive effective date is necessarily valid pursuant to § 7805(b)(6). *See* Act § 309(d)(2); *Cemco*, 515 F.3d at 752.

The IRS issued § 1.752-6 under its general rulemaking authority as well. *See* I.R.C. § 7805(a); T.D. 9062, 2003-2 C.B. 46, 48. The validity of § 1.752-6 as a "general authority" regulation is determined under *Chevron* by reference to § 752. If § 1.752-6 was otherwise validly issued as a general-authority regulation, then the validity of its retroactive effective date turns on whether the IRS properly invoked the anti-abuse provision of § 7805(b)(3).

3. The District Court erroneously concluded that § 1.752-6 cannot be reconciled with the language of Act § 309(c), and therefore erred in holding that the regulation was not validly issued or lawfully made retroactive

The District Court's analysis of Act § 309(c) is flawed in both concept and application. First, by examining *de novo* whether § 1.752-6 is "comparable" to § 358(h), the court conflated the threshold inquiry described above – whether Act § 309(c) authorizes the issuance of a regulation under § 752 – with the ensuing determination whether, under *Chevron*, the IRS's issuance of this particular regulation was a valid exercise of that authority.[27] More importantly, the reasoning behind the court's substantive conclusions about § 1.752-6 in terms of Act § 309(c) – that the regulation is not "comparable" to § 358(h), does not address the "acceleration or duplication" of losses, and does not address "liabilities described in section 358(h)(3)" – does not withstand scrutiny.

a. The District Court's conclusion that § 1.752-6 is not comparable to § 358(h) ignores the plain language of the statute

The District Court's conclusion that § 1.752-6 is not comparable to § 358(h) is easily refuted. As indicated above, § 358(h)(2) sets forth two exceptions to the basis-reduction rule of § 358(h)(1), and § 1.752-6(b)(2) renders one of those exceptions (§ 358(h)(2)(B)) inapplicable in the case of Notice 2000-44 transactions. In seizing upon this "exception to the exception," the court disregarded the fact that the exceptions set forth in § 358(h)(2) are prefaced by the clause "Except as provided by the Secretary." Inasmuch as Congress expressly authorized the Secretary

[27] The District Court's action in that regard is the equivalent of a court determining whether a general-authority regulation is "needful" as provided in § 7805(a).

to alter the § 358(h)(2) exceptions in the corporate context, it is nonsensical to suggest that Congress's call for comparable rules in the partnership context – set forth in the very same Act § 309 – would not include the same authority to alter the § 358(h)(2) exceptions. *Cf.* Treas. Reg. § 1.358-5 (eliminating the § 358(h)(2)(B) exception altogether in the corporate context).

b. The District Court's discussion of accelerated or duplicated losses is both too narrow and inaccurate

Having erroneously concluded that Act § 309(c) did not authorize the Secretary to exclude Notice 2000-44 transactions from the § 358(h)(2)(B) exception, the District Court compounded its error by analyzing whether § 1.752-6 prevents the acceleration or duplication of losses solely in terms of Notice 2000-44 transactions. According to the court:

> The transactions described in Notice 2000-44 result in a single loss that occurs at a specific time: liquidation of the inflated-basis assets. Accordingly, to the extent the Treasury created an "exception to the exception" for Notice 2000-44 transactions, it exceeded the statutory grant of authority to "prescribe rules … to prevent the acceleration or duplication of losses … in transactions involving partnerships." …

(App. 155 [first two ellipses in original].) Inasmuch as § 1.752-6 is not limited to Notice 2000-44 transactions, the court failed to consider whether it prevents the acceleration or duplication of losses outside the context of Notice 2000-44 (it does). And the court's bald assertion that Notice 2000-44 transactions do not "lend themselves to duplicated or accelerated losses" (App. 155) is wrong in any event.

In the example that appears in the legislative history of Act § 309, the inflated-basis stock results from the transferee corporation's assumption of a transferor liability that is both contingent and deductible upon payment. See note 24, *supra.* In that situation, "[t]he transferor may then attempt to accelerate the deduction that would be attributable to the liability, by selling or exchanging the transferee stock at a loss." S. Rep. No. 106-120, at 215 (1999); *see also* S. Rep. No. 106-201, at 47 (1999). The exact same possibility exists in the partnership context; that is, if the transferor and the transferee in the example in the legislative history were a partner and a partnership rather than a shareholder and a corporation, the contributing partner could accelerate the future deductions attributable to the contingent liability assumed by the partnership by immediately selling his partnership interest, just as surely as the shareholder in the example could do so by immediately selling his stock. Thus, § 1.752-6 indisputably prevents the acceleration of losses described in the legislative history of Act § 309.

We note further that the District Court's assertion that "transactions described in Notice 2000-44 do not involve accelerated or duplicated losses" (App. 155) is demonstrably wrong. Indeed, viewing each long and short option comprising the tax trades in this case separately – as the court insisted we must (App. 144-145) – reveals that the close-out of each option pair produced roughly offsetting gains and losses. (App. 503.) Thus, the same options that gave rise to taxpayers' claimed $60 million loss also gave rise to millions of dollars of trading losses that were used to offset a similar amount of trading gains – a duplication that § 1.752-6 would indisputably prevent.

c. The District Court erroneously interpreted the term "liabilities described in section 358(h)(3)"

The District Court also erred in concluding that the directive "to issue regulations relating to 'the assumption of liabilities described in section 358(h)(3)' can only be interpreted to relate to contingent liabilities assumed in a corporate exchange … [b]ecause § 358(h)(3) applies only to liabilities that are assumed in an exchange … between a corporation and its shareholders." (App. 156.) In that regard, Act § 309(c)(1) does not refer to liabilities to which § 358(h)(1) (the operative provision) *applies*; rather, it refers to liabilities *described in* § 358(h)(3) (a purely definitional provision). *See Busse v. Commissioner*, 479 F.2d 1147 (7th Cir. 1973) (exception in former § 483(f)(4) for transfers "described in section 1235(a)" did not require that the transfer so *described* also be a transfer to which the capital gain rule of § 1235 *applied*); *cf. Coltec*, 454 F.3d at 1350-51 (interpreting the reference in § 358(d)(2) to "any liability excluded under section 357(c)(3)" to mean a liability of the type described in § 357(c)(3) rather than a liability to which the exclusion rule of § 357(c)(3) actually applied); *Black & Decker*, 436 F.3d at 439-440 (same). The court's reading of Act § 309(c)(1) thus is simply wrong.

4. The legislative history of Act § 309(c) establishes that Congress intended to authorize the issuance of regulations under § 752

As discussed above, when Congress first passed legislation (H.R. 2488) that included a provision addressing the contribution-assumption problem in the corporate context, the accompanying conference report specifically urged the Treasury Department to "apply similar rules (for example, with respect to adjustments to the basis of a partnership interest with respect to certain contingent liabilities) … [to] transaction[s] that include[ ] the assumption of liabilities by a partnership." H.R. Conf. Rep. No. 106-289, at 538 (1999). This strong suggestion that the Secretary apply similar rules in the partnership context became an express directive in the next iteration of the legislation, passed by the Senate about a month after H.R. 2488 was vetoed, and in all subsequent iterations. In light of the specific reference in the H.R. 2488 conference report to assumptions of liabilities by partnerships (and the reference to the H.R. 2488 conference report in the committee reports accompanying S. 1792 and H.R. 5542), surely Congress would have expressly limited the scope of Act § 309(c)(1) to § 358 transactions if that had been its intention. Given the abuse being targeted, the more plausible explanation for the use of the more general term "transactions involving partnerships" in Act § 309(c)(1) is that Congress intended the grant of authority to be broad enough to encompass both partnership assumptions of liabilities *and* § 358 transactions involving partnerships. *See* Treas. Reg. § 1.358-7.

In sum, as held by the Seventh Circuit in *Cemco*, as well as by the district court in *Maguire Partners*, the Treasury properly issued Treas. Reg. § 1.752-6 under the specific Congressional directive in Act § 309(c)(1) that included the express authority to make the regulation applicable retroactively to October 19, 1999. *See* I.R.C. § 7805(b)(6) (Treasury may prescribe the effective date of any regulation where there is a legislative grant of that authority).

5. The District Court further erred in concluding that § 1.752-6 could not have been validly issued as a general-authority regulation

Although the District Court addressed two separate issues – whether § 1.752-6 (apart from its retroactive feature) is a valid general-authority regulation under § 7805(a), and if so, whether the IRS properly invoked § 7805(b)(3) to make it retroactive – as one, it essentially rejected both contentions on the ground that § 1.752-6 is contrary to § 752.[28] Presumably the court reasoned that § 752 (as

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[28] Actually, the court focused mainly on the alleged inconsistency (continued...)

interpreted in a trio of Tax Court cases), unlike § 1.752-6, does not apply to contingent liabilities. In those cases, however, the Tax Court did not conclude (nor could it have) that § 752 admits of only one permissible interpretation in that regard. *See Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 985 (2005) ("Before a judicial construction of a statute, whether contained in a precedent or not, may trump an agency's, the court must hold that the statute unambiguously requires the court's construction."); *cf. Kornman & Assocs., Inc. v. United States*, 527 F.3d 443 (5th Cir. 2008) (obligation to close a short sale treated as a liability for purposes of I.R.C. § 752). Since the plain meaning of the term "liability" in § 752 is broad enough to encompass contingent liabilities (and since there is no helpful legislative history under § 752 on this issue), it follows that § 1.752-6 (and the prospective rules under § 1.752-7, for that matter) – adopting a special set of basis rules applicable to that particular subset of

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[28](...continued)
with § 358(h), which is only relevant to the issue whether § 1.752-6 is valid under Act § 309(c). In any event, we have previously demonstrated that § 1.752-6 is entirely consistent with § 358(h). See Part III.B.3.a., *supra*.

liabilities – does not contradict § 752. *See Maguire Partners*, 2009 WL 279100 at *19.

6. As neither Act § 309(c) nor I.R.C. § 752 precludes a regulation addressing partnership assumptions of contingent liabilities, the operative aspect of § 1.752-6 is entitled to *Chevron* deference

Although the District Court acknowledged (App. 152) that it was bound to accord *Chevron* deference to § 1.752-6 if the regulation was authorized by Act § 309(c), it erroneously concluded (App. 157) that general-authority tax regulations are only entitled to *Skidmore* deference. See p. 74, *supra*. *Mead* confirmed, however, that general-authority agency pronouncements are entitled to *Chevron* deference if Congress intended them to have the force of law, and several Courts of Appeals have recognized that general-authority tax regulations fall into this category. *See Khan v. United States,* 548 F.3d 549, 554 (7th Cir. 2008); *Swallows Holding, Ltd. v. Commissioner*, 515 F.3d 162, 169-70 (3d Cir. 2008); *McNamee v. Dept. of Treasury*, 488 F.3d 100, 106 (2d Cir. 2007); *Hospital Corp. of America & Subs. v. Commissioner*, 348 F.3d 136, 140-41 (6th Cir. 2003).

In the context of Act § 309(c), the issue under *Chevron* is whether the Commissioner acted arbitrarily or capriciously in determining that a regulation under § 752 that excludes Notice 2000-44 transactions from the applicability of the § 358(h)(2)(B) exception is "comparable" to § 358(h). We have already demonstrated that, given the prefatory clause of § 358(h)(2), the statute certainly does not compel the District Court's *de novo* conclusion that § 1.752-6 is not comparable to § 358(h). It inexorably follows that the Commissioner did not act arbitrarily or capriciously in determining that § 1.752-6 *is* comparable to § 358(h).

In the context of § 7805(a), the issue under *Chevron* is whether § 1.752-6 (apart from its retroactive feature) represents a reasonable application of § 752 principles to contingent liabilities. Taking into account the "escape hatch" of § 1.752-6(d)(2), there is no question that the regulation is a valid exercise of rulemaking authority under *Chevron*. Under that provision, any partnership otherwise affected by the up-front basis-reduction rule of § 1.752-6(a) could elect to apply instead the rules of § 1.752-7. Under those much more nuanced rules, any "one-time" basis reduction is delayed until the occurrence of certain "separation" events. *See* REG-106736-00, 68 Fed. Reg. 37434, 37437

(2003). Moreover, § 1.752-6 does not represent a trap for the unwary shelter participant; the application of § 1.752-7 to the abusive in-and-out transactions at which § 1.752-6 is targeted (such as the Deerhurst GP transaction) would produce the exact same result. *See* Treas. Reg. § 1.752-7(f). Accordingly, § 1.752-6 (and, by extension, § 1.752-7) represents a reasonable implementation of § 752 principles in the context of contingent liabilities. *See Maguire Partners*, 2009 WL 279100 at *19.

7. Even if § 1.752-6 were only valid as a general-authority regulation, its retroactivity would be authorized under § 7805(b)(3)

In conflating the Commissioner's general rulemaking authority under § 7805(a) with his discretion under § 7805(b)(3) to make any such regulation retroactive if necessary to prevent abuse, the District Court erroneously surmised that the two exercises are subject to the same standard of review. As indicated above, the Commissioner's general authority to issue retroactive regulations under pre-1996 law was subject to judicial review for abuse of discretion. Nothing in the legislative history of the 1996 amendments to § 7805(b) suggests that

Congress intended a different standard of review to apply to the Commissioner's invocation of § 7805(b)(3).

In any event, the Commissioner's invocation of § 7805(b)(3) with respect to § 1.752-6 was permissible whether it is reviewed for abuse of discretion or in accordance with *Chevron*. Congress specifically contemplated that regulations shutting down contingent liability shelters in the partnership context were an appropriate candidate for retroactivity under § 7805(b)(3). *See* H.R. Conf. Rep. No. 106-289, at 538 (1999) (quoted at p. 68, *supra*). Moreover, no one was blindsided here; taxpayers were well aware of the IRS's position that the general principle of *Helmer v. Commissioner*, 34 T.C.M. (CCH) 727 (1975), did not support the creation of artificial tax losses through the use of offsetting options. *See* Notice 2000-44, 2000-2 C.B. 255; *see also Cemco,* 515 F.3d at 751 (upholding the validity of § 1.752-6 and rejecting Cemco's contention that "it was just relying on *Helmer* … and a few similar decisions"); *Maguire Partners*, 2009 WL 279100 at **19-20. Finally, the "escape hatch" of § 1.752-6(d)(2) ensured that any affected partnership that had engaged in a legitimate § 752 transaction involving contingent liabilities could avoid the up-front basis-reduction rule of § 1.752-6(a). For all these reasons, the Commissioner acted well within the bounds of § 7805(b)(3) in making § 1.752-6 retroactive.

IV

The District Court abused its discretion in denying the Government's motion for new trial

Standard of review

The District Court's denial of the Government's motion for new trial is reviewed for abuse of discretion. *Henning v. Union Pac. R.R. Co.*, 530 F.3d 1206, 1216-17 (10th Cir. 2008); *see also Kilgore v. Attorney Gen. of Colorado*, 519 F.3d 1084, 1086 (10th Cir. 2008) (abuse of discretion can be based on a clearly erroneous finding of fact or an erroneous conclusion of law, as well as on a clear error of judgment).

Issue raised and ruled on

The Government raised this issue in its motion for new trial filed June 10, 2008. (App. 167-169.) The District Court ruled on this issue in an order entered July 18, 2008. (App. 324-334.)

A. Introduction

Although, as demonstrated above, this Court should reverse the judgment of the District Court on the loss issue, at the very least the

Government is entitled to a new trial based on Andrew Krieger's sworn, post-trial recantation of his deposition testimony (which was admitted as his trial testimony). Krieger's deposition testimony goes to the heart of taxpayers' claim of economic substance in general and business purpose in particular. The importance of the recanted testimony to the court's decision is evidenced by the fifteen direct references to it contained in the court's opinion, ten of which serve to corroborate Sala's testimony, which the court then heavily relied on in reaching its decision. (App. 115, 127, 129, 131-134, 146-147.)

B. Law and Analysis

In order to warrant a new trial, the information contained in Krieger's sworn recantation (1) must have been newly discovered since trial, and the Government must have been diligent in discovering it; (2) must not be merely cumulative or impeaching; and (3) must be material, such that a new trial would probably produce a different result. *See Joseph v. Terminix Int'l Co.*, 17 F.3d 1282, 1285 (10th Cir. 1994). We address these requirements in turn.

1. Krieger's recantation constitutes evidence that was newly discovered since trial, and the Government was diligent in discovering it

Although the Government did not procure Krieger's sworn recantation until after the trial, the District Court determined that the information contained therein was not newly discovered "in light of the fact that the Government received an itemized letter delineating the content of Krieger's May 22, 2008, declaration as early as March 12, 2008." (App. 329.) Even a cursory review of the referenced documents reveals that this factual assertion is clearly erroneous. The only information common to the March 12 letter from Krieger's attorney and the May 22 declaration of Krieger himself are bare citations to the deposition transcript. In his May 22 declaration, Krieger admitted under oath that his deposition testimony was false and misleading in a material way *and* he specified in detail how his deposition testimony was false and/or intentionally misleading. (App. 211-214.) On the other hand, the March 12 letter provided no indication whatsoever regarding *how* the referenced deposition excerpts were inconsistent with statements Krieger made to the U.S. Attorney's office. Thus, it did not, contrary to the District Court's statement, in any meaningful sense "delineat[e] the content of Krieger's May 22, 2008, declaration." (App. 329.)

The March 12 letter stated that a Mr. Tilem, "of counsel" to the law firm of Mr. Fischer, Krieger's attorney, had identified five sections from Krieger's deposition that *Tilem* thought to be "inconsistent" with Krieger's statement to the U.S. Attorney. (App. 220-222.) The letter also contained references to several other parts of the deposition transcript that the *U.S. Attorney's office* thought were "inconsistent." (App. 222.) The letter, unlike Krieger's post-trial declaration, contained no admissions by Krieger himself that his deposition testimony was false and intentionally misleading. Indeed, Krieger made clear in his declaration that, because of his fear of self-incrimination, he was unwilling to admit, prior to reaching an agreement with the U.S. Attorney's office, that any aspect of his deposition testimony was false or intentionally misleading. (App. 211-212.)

The March 12 letter thus basically was no different than the February 27 letter from Krieger's attorney that the Government had brought to the District Court's attention in an attempt to have the court postpone the trial until Krieger could be called as a witness or to have the court exclude Krieger's deposition from the trial. The court ruled, however, that the statements in the February 27 letter were hearsay and, in any event, too vague and indefinite to establish that any specific portion of Krieger's deposition testimony was false or intentionally misleading. (App. 313-314, 558-560.) The court thus did not afford the Government any relief in this regard. In light of the court's ruling, the Government had no reason to believe that the court would regard the March 12 letter as being more pertinent than the February 27 letter, since all of the statements in the March 12 letter were hearsay and there was no admission by Krieger himself in the letter that any of his previous deposition testimony was false or intentionally misleading. (App. 258-259.)

The District Court's related conclusion – that, inasmuch as Krieger informed the U.S. Attorney's office at some point in 2007 that some of his deposition testimony in this case was false, the Government was not diligent in procuring his sworn recantation (App. 331-332) – is also without merit. First, the court erroneously imputed the knowledge of federal prosecutors in the U.S. Attorney's office for the Southern District of New York to the Tax Division's civil trial attorneys. As the

Assistant U.S. Attorney informed the court in her sworn declaration (App. 268-269), her office did not disclose Krieger's statements to the Tax Division attorneys trying this case for fear of violating grand jury secrecy rules. The trial attorneys in this case did not learn of Krieger's discussions with the U.S. Attorney's office until they received the February 27 letter from Krieger's counsel. (App. 256.) Second, the court's reference to "the Government's demonstrated power to wield the Sword of Damocles to secure a non-prosecution agreement" (App. 332) fails to recognize that Krieger resided in Dubai continuously since August 2007 and, in the weeks prior to and during this trial, was out of the country. (App. 212.)

2. The information contained in Krieger's sworn recantation is not merely cumulative or impeaching

Most of the District Court's order denying the Government's motion for new trial is devoted to the erroneous proposition that all but one of the statements contained in Krieger's sworn recantation were either cumulative or impeaching. Of particular note here is the court's apparent conviction that, since a recantation of prior testimony necessarily disputes, denies, or contradicts (*i.e.*, impeaches) that testimony, it can never constitute "new" evidence that would support a new trial. (App. 329-330.) That is obviously a misapplication of the law. *See United States v. Ramsey*, 726 F.2d 601, 604-05 (10th Cir. 1984) (trial court abused its discretion in denying, without a hearing and without making any findings of fact, a motion for a new trial on the basis of recanted testimony; recantation was not merely impeaching or cumulative); *see also United States v. Page*, 828 F.2d 1476, 1478 (10th Cir. 1987).

The District Court thus refused to consider several critical statements from Krieger's recantation on the erroneous ground that they were *per se* impeaching. Those statements include: (1) that Krieger would not have made the tax trades (*i.e.*, the trades creating Sala's fictional $60 million loss) but for the need to generate tax losses; (2) that the purpose of the "test period" was to disguise the true nature of the Deerhurst GP transaction from the IRS, not to "ease people gently into foreign exchange trading" (App. 214); (3) that the structure of the Deerhurst GP transaction had no purpose other than the creation of tax losses; and (4) that there was no purpose in liquidating the tax trades at the end of 2000 other than achieving tax losses. (App. 330.)

Those statements, which directly contradict Krieger's deposition testimony – testimony that the District Court heavily relied on in concluding that the Deerhurst GP transaction was a legitimate, business-motivated transaction – confirm that the Deerhurst GP transaction had no business purpose whatsoever and was nothing more than the abusive tax shelter transaction described in Notice 2000-44.

3. The information contained in Krieger's sworn recantation plainly is sufficiently material to produce a different outcome in a new trial

Having erroneously concluded that only one of the statements in Krieger's declaration constituted "new," non-impeaching evidence, the District Court unsurprisingly found that this new information would not alter the outcome of the case. (App. 331.) In contrast, the statements in Krieger's declaration erroneously excluded by the court from consideration as "impeaching" eviscerate taxpayers' case. Indeed, the District Court's validation of the claimed business purpose for the Deerhurst GP transaction contains no less than eleven direct references to deposition testimony repudiated by Krieger in his post-trial declaration. (App. 129, 131-134.)

In these circumstances, it is apparent that the District Court's reliance on critical deposition testimony by Krieger, which Krieger specifically repudiated in his post-trial declaration, denied the Government a fair trial and that the court, consequently, abused its discretion in denying the Government a new trial at which Krieger could have been called as a witness by the Government. Accordingly, in the event this Court were to conclude that the District Court did not otherwise commit any reversible errors in its resolution of the underlying tax issues in this case, the case should be remanded for a new trial.

CONCLUSION

This Court should reverse the judgment of the District Court upholding the fictitious $60 million tax loss claimed by the taxpayers. In the alternative, the Court should remand the case for a new trial.

STATEMENT REGARDING ORAL ARGUMENT

The Government submits that oral argument would significantly assist the Court in resolving this appeal, which has great importance to the proper administration of the tax laws.

Respectfully submitted,

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STATUTORY AND REGULATORY ADDENDUM

Internal Revenue Code (26 U.S.C.):

CHAPTER 1 – NORMAL TAXES AND SURTAXES

* * * * *

Subchapter A – Determination of Tax Liability

* * * * *

Sec. 165. Losses.

(a) General Rule. – There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

(c) Limitation on Losses of Individuals. – In the case of an individual, the deduction under subsection (a) shall be limited to –

* * * * *

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business …

* * * * *

Subchapter C – Corporate Distributions and Adjustments

* * * * *

Sec. 358. Basis to Distributees.

(a) General Rule.—In the case of an exchange to which section 351, 354, 355, 356, or 361 applies –

(1) Nonrecognition Property.—The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged –

(A) decreased by –

* * * * *

(ii) the amount of any money received by the taxpayer …

* * * * *

(d) Assumption of Liability.—

(1) In General.—Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer, such assumption shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

* * * * *

(h) Special Rules for Assumption of Liabilities to Which Subsection (d) Does Not Apply.—

(1) In General.—If, after application of the other provisions of this section to an exchange or series of exchanges, the basis of property to which subsection (a)(1) applies exceeds the fair market value of such property, then such basis shall be reduced (but not below such fair market value) by the amount (determined as of the date of the exchange) of any liability –

(A) which is assumed by another person as part of the exchange, and

(B) with respect to which subsection (d)(1) does not apply to the assumption.

(2) Exceptions.—Except as provided by the Secretary, paragraph (1) shall not apply to any liability if –

(A) the trade or business with which the liability is associated is transferred to the person assuming the liability as part of the exchange, or

(B) substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange.

(3) Liability.—For purposes of this subsection, the term "liability" shall include any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of this title.

*　　*　　*　　*　　*

Subchapter K – Partners and Partnerships

*　　*　　*　　*　　*

Sec. 722. Basis of Contributing Partner's Interest.

The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution ...

* * * * *

Sec. 732. Basis of Distributed Property Other Than Money.

* * * * *

(b) Distributions in Liquidation.—The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in such transaction.

* * * * *

Sec. 733. Basis of Distributee Partner's Interest.

In the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by –

(1) the amount of any money distributed to such partner ...

* * * * *

Sec. 752. Treatment of Certain Liabilities.

(a) Increase in Partner's Liabilities.—Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

(b) Decrease in Partner's Liabilities.—Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

* * * * *

CHAPTER 80 – GENERAL RULES

* * * * *

Sec. 7805. Rules and Regulations.

* * * * *

(b) Retroactivity of Regulations.—

(1) In General.—Except as otherwise provided in this subsection, no temporary, proposed, or final regulation relating to the internal revenue laws shall apply to any taxable period ending before the earliest of the following dates:

(A) The date on which such regulation is filed with the Federal Register.

(B) In the case of any final regulation, the date on which any proposed or temporary regulation to which such final regulation relates was filed with the Federal Register.

(C) The date on which any notice substantially describing the expected contents of any temporary, proposed, or final regulation is issued to the public.

* * * * *

(3) Prevention of Abuse.—The Secretary may provide that any regulation may take effect or apply retroactively to prevent abuse.

* * * * *

(6) Congressional Authorization.—The limitation of paragraph (1) may be superseded by a legislative grant from Congress authorizing the Secretary to prescribe the effective date with respect to any regulation.

* * * * *

Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763A-587 (2000):

Sec. 309. Prevention of Duplication of Loss Through Assumption of Liabilities Giving Rise to a Deduction.

(a) In General.—Section 358 (relating to basis to distributees) is amended by adding at the end the following new subsection:

"**(h) Special Rules for Assumption of Liabilities to Which Subsection (d) Does Not Apply.**—

* * * * *

"**(3) Liability.**— For purposes of this subsection, the term 'liability' shall include any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of this title.".

* * * * *

(c) Application of Comparable Rules to Partnerships and S Corporations.—The Secretary of the Treasury or his delegate –

(1) shall prescribe rules which provide appropriate adjustments under subchapter K of chapter 1 of the Internal Revenue Code of 1986 to prevent the acceleration or duplication of losses through the assumption of (or transfer of assets subject to) liabilities described in section 358(h)(3) of such Code (as added by subsection (a)) in transactions involving partnerships ...

* * * * *

(d) Effective Dates.—

* * * * *

(2) Rules.—The rules prescribed under subsection (c) shall apply to assumptions of liability after October 18, 1999, or such later date as may be prescribed by such rules.

Treasury Regulations (26 C.F.R.):

§ 1.165-1 Losses.

* * * * *

(b) Nature of loss allowable. – To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

§ 1.752-6 Partnership assumption of partner's section 358(h)(3) liability after October 18, 1999, and before June 24, 2003.

(a) In general. If, in a transaction described in section 721(a), a partnership assumes a liability (defined in section 358(h)(3)) of a partner (other than a liability to which section 752(a) and (b) apply), then, after application of section 752(a) and (b), the partner's basis in the partnership is reduced (but not below the adjusted value of such interest) by the amount (determined as of the date of the exchange) of the liability. For purposes of this section, the adjusted value of a partner's interest in a partnership is the fair market value of that interest increased by the partner's share of partnership liabilities under §§ 1.752-1 through 1.752-5.

(b) Exceptions–(1) In general. Except as provided in paragraph (b)(2) of this section, the exceptions contained in section 358(h)(2)(A) and (B) apply to this section.

> **(2) Transactions described in Notice 2000-44.** The exception contained in section 358(h)(2)(B) does not apply to an assumption of a liability (defined in section 358(h)(3)) by a partnership as part of a transaction described in, or a transaction that is substantially similar to the transactions described in, Notice 2000-44 (2000-2 C.B. 255). ...

* * * * *

(d) Effective dates—(1) In general. This section applies to assumptions of liabilities occurring after October 18, 1999, and before June 24, 2003.

> **(2) Election to apply § 1.752-7.** The partnership may elect, under the provisions of REG-106736-00 ... to apply those provisions and related proposed Income Tax Regulations to all assumptions of liabilities by the partnership occurring after October 18, 1999, and before June 24, 2003. ...

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO
LEWIS T. BABCOCK, JUDGE

Civil Case No. 05-cv-00636-LTB

CARLOS E. SALA, and
TINA ZANOLINI-SALA,

Plaintiffs,

v.

UNITED STATES OF AMERICA,

Defendant.

FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER

Babcock, J.

This action concerns a claim by Plaintiffs Carlos E. Sala and Tina Zanolini Sala (referred to herein as "Sala," since Tina Zanolini-Sala is a named plaintiff only because the Salas filed a joint tax return) for a refund on Sala's 2000 federal taxes. Sala timely filed his 2000 federal tax return on or before April 15, 2001. Although Sala had income in 2000 of more than $60 million, he claimed a tax loss that essentially nullified his tax burden. Sala achieved the alleged loss through his involvement in a foreign currency options investment transaction known as Deerhurst. Sala filed an amended return on November 18, 2003, eliminating the loss claimed on his original 2000 return and paying over $26 million in taxes, plus penalties and interest. Sala later filed another amended return reclaiming the tax loss and seeking a refund of the taxes, interest, and penalties. The Government contends Sala is not entitled to claim the tax loss because Deerhurst was an improper tax shelter. Sala disagrees, and brought suit against the Government to obtain a refund of the taxes, interest, and penalties he paid to the Government.

An eight day trial to the Court in this matter was held commencing March 10, 2008, and concluding March 19, 2008. The two claims at issue were Sala's entitlement to a refund of the taxes, penalties, and interest he paid on his 2000 income and—to the extent any refund was due Sala on putatively "excess" interest—the Government's entitlement to an accuracy-related penalty owed, but not assessed. After a review of all the evidence presented both at trial and by deposition, I find in favor of Carlos Sala and Tina Zanolini-Sala and against the Government on all claims and counterclaims.

I. BACKGROUND FACTS

The following facts are not disputed. In 1997, Sala became employed as CFO, Secretary, and Treasurer of Abacus Direct, Inc. Sala's compensation included cash and stock options. In June 1999, Abacus was acquired by DoubleClick, Inc. In connection with the acquisition, Sala received DoubleClick stock options. Sala sold his DoubleClick options in February or March of 2000. Largely as a result of the sale of these options, Sala realized more than $60 million in income in 2000.

Sala invested most of this income into municipal bonds and other fixed income financial products. Approximately $9 million, however, was invested in a foreign currency investment program, which is collectively referred to herein as the "Deerhurst Program." As part of the Deerhurst Program, Sala deposited $500,000 on October 23, 2000, into a personal account at Refco Capital Markets ("Refco") that was managed by Deerhurst Management Company, Inc.

("Deerhurst Management"). Deerhurst Management was principally owned and managed by Andrew Krieger, a renowned foreign currency trader.

On November 21, 2000, Sala deposited an additional $8,425,000 into his personal account at Refco. Between November 20 and November 27, 2000, Deerhurst Management acquired 24 foreign currency options on Sala's behalf. The options consisted of both long and short options in various foreign currencies with a net cost to Sala of approximately $728,297.85.

On November 8, 2000, Sala formed Solid Currencies, Inc. ("Solid" or "Solid Currencies")—a Delaware S Corporation in which he was the sole shareholder. On November 28, 2000, Sala transferred the 24 options, plus approximately $8 million in cash, to Solid and then from Solid to Deerhurst Investors, GP, ("Deerhurst GP") in exchange for a partnership interest. Deerhurst GP was liquidated prior to December 31, 2000. Upon liquidation of Deerhurst GP, Solid received a share of the proceeds. Solid transferred its share of the Deerhurst GP proceeds to Deerhurst Trading LLC. Krieger continued to manage these funds on behalf of Sala in various entities through 2004.

On or before April 15, 2001, Sala filed a corporate income tax return for Solid for the 2000 tax year. The return was prepared and signed by David Schwartz, the brother of Michael Schwartz—the person who introduced Sala to the Deerhurst Program. The return reported an ordinary loss from a trade or business of $60,449,984.

The approximately $60 million loss claimed was allegedly achieved by a series of predetermined steps, orchestrated under a then-existing tax rule that disregarded short options as liabilities for purposes of establishing partnership basis. Under this rule, established in *Helmer v. Commissioner of Internal Revenue*, T.C. Memo. 1975-160 (1975), liabilities created by short options were considered too contingent to affect a partner's basis in the partnership. Upon transfer of the 24 foreign currency options from Sala to Solid and then to Deerhurst GP, Solid's basis in Deerhurst GP was increased by the value of the long options, $60,987,866.79, but was not offset by the $60,259,568.94 cost of the short options. Accordingly, Solid's claimed basis in Deerhurst GP was approximately $69 million—the value of the cash plus the long options.

Upon liquidation of Deerhurst GP, Solid received a portion of Deerhurst GP's liquidated assets equal to the proportionate size of Solid's basis. Solid claimed to have received approximately $8 million in cash and two foreign currency contracts. Under the Tax Code, the foreign currency contracts were considered to be "property" at transfer. The value of the foreign exchange contracts distributed to Solid, therefore, was claimed to be approximately $61 million—$69 million (Solid's original basis in Deerhurst GP) less the $8 million in cash. When Solid sold the foreign currency contracts, its loss was equal to the $61 million dollar value of the contracts, offset by any profit received from their sale. According to Solid's 2000 tax return, the combined loss on the foreign currency contracts was approximately $60,250,065.94. When combined with Solid's other expenses and losses, Solid's 2000 loss was reported as $60,449,984.

On or before April 15, 2001, Sala filed a personal federal income tax return for the 2000 year ("2000 return"). The 2000 return reported wages of $51,748,681; taxable interest income of $1,837,561; dividend income of $410,300; taxable refunds, credits, or offsets of state and local income taxes of $7,846; a capital gain of $6,472,000; and other income of ($23). The 2000 return reported on line 17 (rental real estate, royalties, partnerships, S corporations, trusts, etc.) the $60,449,984 loss attributed to a non-passive loss from Solid Currencies. The 2000 return reported adjusted gross income of $26,381. Sala reported owing no federal taxes.

In November 2003, Sala filed a form 1040X amending his 2000 return. The amended return reported the same income amounts as the original return, but did not report the $60,449,984 loss previously attributed to Solid Currencies. Sala paid the resulting approximately $26 million in taxes, interest, and penalties. On or about June 18, 2004, the IRS issued a Notice of Deficiency to Sala, asserting he owed additional taxes in the amount of $22,204 due to the disallowance of $56,071 of losses Sala reported as attributable to Solid Currencies. The Notice of Deficiency also asserted an accuracy-related penalty in the amount of $4,400.80 for tax year 2000.

In September 2004, Sala filed another form 1040X for the 2000 tax year reclaiming the loss attributable to Solid Currencies and claiming a refund due of $23,727,630.

In the Amended Pretrial Order [Docket # 195], the parties stipulated to the following additional relevant facts. In late 1999, Sala was introduced to KPMG partner Tracie Henderson through Sala's friend Tim Gillis—also a KPMG partner. KPMG prepared Sala's federal and state tax returns for the years 2000, 2001, 2002, and 2003. Prior to 2000, Sala's tax returns were prepared by PricewaterhouseCoopers.

On August 13, 2000, IRS Notice 2000-44 was released electronically; on September 18, 2000, it was published.

On or about April 15, 2001, Sala paid R. J. Ruble $75,000 for a tax opinion letter involving the tax benefits of the Deerhurst Program.

II. ISSUES PRESENTED AT TRIAL

Five distinct issues were presented at trial: (1) whether the transactions creating Sala's 2000 tax loss constituted sham transactions; (2) whether Sala entered into the transactions creating his 2000 tax loss for profit; (3) whether the transactions creating Sala's 2000 tax loss, as executed, allowed the tax loss; (4) whether any allowable tax loss was rendered retroactively disallowed by 26 C.F.R. § 1.752-6; and (5) whether the Government is entitled to an offset of any excess interest payments made by Sala with an accuracy-related penalty. The second issue is an issue of fact. *See Hildebrand v. Comm'r of Internal Revenue*, 28 F.3d 1024, 1026 (10th Cir. 1994). The fourth issue is a question of law. The remaining issues are mixed questions of law and fact.

Before addressing these issues, however, it is necessary to define the appropriate burden of proof in this case and define the scope of the loss-generating transaction.

III. BURDEN OF PROOF

The allocation of burdens as to each specific factual issue will be addressed where appropriate throughout this order. I therefore lay out only the general framework here.

Under 26 U.S.C. § 7491, when a taxpayer produces credible evidence with respect to any factual issue relevant to ascertaining the taxpayer's liability, the Government has the burden of proof with respect to such factual issue so long as (1) the taxpayer has complied with the requirements of the Tax Code to substantiate any item, and (2) the taxpayer has maintained all records required and has cooperated with reasonable requests for witnesses, documents, meetings, and interviews.

It cannot genuinely be disputed that Sala has complied with the requirements of the Tax Code to substantiate each of his factual claims and that Sala has maintained all records required and has cooperated with reasonable requests for witnesses, documents, meetings, and interviews. Sala has provided the Government with thousands of pages of records, including written explanations and other supporting information substantiating his factual claims. Moreover, Sala consented to extending the period in which the IRS could assess an additional tax deficiency for the 2000 tax year. Sala's cooperation with the IRS was clearly sufficient to meet the requirements under § 7491. Accordingly, the Government has the burden of proof as to each issue of fact so long as Sala supports his factual account with credible evidence. For the purposes of § 7491, "credible evidence . . . is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness)." *Griffin v. Comm'r of Internal Revenue*, 315 F.3d 1017, 1021 (8th Cir. 2003).

When considering penalties, however, the burden of production is on the Government to make a *prima facie* case that penalties should apply. If the Government meets this burden, the burden then shifts to Sala to show his underpayment was not the result of negligence and that he did what a reasonably prudent person would have done under the circumstances. *Sparkman v. Comm'r of Internal Revenue*, 509 F.3d 1149, 1161 (9th Cir. 2007); *Van Scoten v. Comm'r of Internal Revenue*, 439 F.3d 1243, 1258 (10th Cir. 2006). The determination of whether a taxpayer meets his burden of proving due care is a factual one. *Mortensen v. Comm'r of Internal Revenue*, 440 F.3d 375, 385 (6th Cir. 2006).

IV. SCOPE OF THE LOSS-GENERATING TRANSACTION

Before analyzing whether Sala was entitled to the loss allegedly generated by the Deerhurst Program, it is necessary to define the scope of the "transaction" that caused the loss. I must look beyond the form of the Deerhurst Program to determine whether the portion of the program that created the loss is bona fide. *See Rogers v. United States*, 281 F.3d 1108, 1114–17

(10th Cir. 2002). I examine Sala's involvement in the Deerhurst Program as a whole, considering each step, to determine if the substance of the transaction is consistent with its form. *ACM P'ship v. Comm'r of Internal Revenue*, 157 F.3d 231, 246–48 (3d Cir. 1998). The "transaction" to be analyzed is the transaction that gave rise to the particular tax benefit, not collateral transactions which do not produce the tax benefits. *See James v. Comm'r of Internal Revenue*, 899 F.2d 905, 910 (10th Cir. 1990). So long as the transaction that creates the tax benefit is bona fide, any tax benefit achieved will be presumed legitimate. *See Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1356–57 (Fed. Cir. 2006) (discussing cases).

The threshold issue, therefore, is whether (a) the "transaction" includes only the portions of the Deerhurst Program occurring in 2000—that is, Sala's purchase of the 24 foreign currency option contracts and the subsequent transfers from Sala to Solid Currencies and from Solid Currencies to Deerhurst GP, the subsequent sale of the contracts, and the return to Solid of a reported $8 million in cash and two foreign currency contracts—or (b) whether the "transaction" also includes the reinvestment of the Deerhurst GP liquidation proceeds into Deerhurst LLC and the trading occurring from 2001 onward. For the reasons stated below, I find and conclude that—for purpose of determining whether the loss-generating transaction was bona fide—both the Deerhurst GP portion of the Deerhurst Program and the Deerhurst LLC portion of the Deerhurst Program must be considered together as a single transaction.

A. Findings of fact

The subjective intent of the parties to a loss-generating transaction is a significant factor when determining whether the transaction was bona fide. *See, e.g., Klamath Strategic Inv. Fund, LLC v. United States*, 472 F. Supp. 2d 885, 896–98 (E.D. Tex. 2007). Sala testified at trial that his participation in the Deerhurst Program was undertaken in accordance with a five year plan. Under the plan, potential Deerhurst investors were required to place a minimum of $500,000 into a Refco account, to be traded on each individual's behalf by Krieger through Deerhurst. Investors were free to withdraw their funds without penalty at any time during this initial test period. If investors desired to continue investing in Deerhurst, they were required to deposit additional funds—which combined were to equal at least 15% of their expected tax loss—into a Deerhurst GP account. This second round of investment was to remain under Deerhurst management through 2000. If the Deerhurst GP account was profitable after liquidation in late 2000, investors were required to reinvest their liquidation proceeds in Deerhurst LLC for a minimum of five years, or face a significant early-withdrawal penalty. Sala's testimony—which was not contradicted by any Government evidence—was both credible and well-supported by documentary evidence and the deposition testimony of Michael Schwartz, Martin White—a friend of Sala who also was a significant Deerhurst investor—and Andrew Krieger. I accept Sala's testimony in this regard as fact.

Sala testified that he viewed his investment in the Deerhurst Program to be part of one continuous transaction lasting five years. This testimony was uncontradicted. Accordingly, I conclude Sala subjectively viewed his participation in the Deerhurst Program to be a single transaction.

The behavior of the other Deerhurst Program investors also supports the conclusion that the Deerhurst GP program and the Deerhurst LLC program were understood by the investors to comprise one transaction. Martin White testified by deposition that "at a certain point, you needed to be either in or out. And if you were in, you were in for, I think it was four years. And that was it. You were in, you were locked in . . . your investment was sort of illiquid at that point." Although one investor, Joe Umback, withdrew from the initial test phase of the Deerhurst Program—without ever investing in the Deerhurst GP portion of the program—every investor who participated in Deerhurst GP also invested in Deerhurst LLC despite the fact that the Deerhurst LLC portion had no tax benefits. This demonstrates that the investors in the Deerhurst understood their obligation—once they had profitably invested in the Deerhurst GP portion of the Deerhurst Program—to invest in the five-year combined program.

B. Case law analysis

The Government argues that the focus of my inquiry must be upon the Deerhurst GP portion of the Deerhurst Program alone, as the Deerhurst GP portion achieved the 2000 tax loss. I am unconvinced.

The cases cited by the Government do not concern the question presented here—whether a loss generated in the first year of an ongoing multi-year investment relationship between two parties must be analyzed on its own. For example, in *James* the Tenth Circuit addressed whether lease transactions between certain joint ventures—which reported a tax loss—and an entity engaged in the purchase and lease of computer equipment could be found to lack economic substance when the purchases and lease transactions themselves were legitimate. *See James*, *supra*, 899 F.2d 905. The court relied on the fact that the legitimate transactions were undertaken by entities independent from those claiming the tax loss. Rejecting the argument that the loss-generating arrangements and the purchase and lease arrangements were one "unitary deal," the court noted "there were many individual actors and many individual transactions." *Id.* at 910. The court held that the purchase-and-lease entity "never actually purchased equipment 'on behalf of' the joint ventures, but instead executed separate purchase agreements with them." *Id.* at 909. Thus, the legitimate purchase and lease contracts were independent of the loss-generating arrangements between the purchase-and-lease entity and the joint ventures and the latter were not "legitimized merely because they were on the periphery of some legitimate transactions." *Id.*

Likewise, in *Nicole Rose Corp. v. Comm'r of Internal Revenue*, 320 F.3d 282 (2d Cir. 2003), the court addressed whether an otherwise sham loss-generating transaction could be found to have economic substance because it offset profits from other associated transactions. The taxpayer claimed a loss of $22 million achieved from the transfer of certain leases of European computer equipment to a European bank. *Id.* at 283. Contemporaneous with the lease transfers, the taxpayer bought and sold a third corporation, realizing a profit of $11 million. *Id.* at 284. Rejecting the taxpayer's argument that the two transactions should be considered together for purposes of determining economic substance, the Second Circuit held that income generated from the purchase and sale of the third corporation was irrelevant to the inquiry whether the lease transfer had economic substance. *Id. Nicole Rose* did not concern whether the loss-generating portion of an ongoing investment relationship between two parties must be analyzed on its own for economic substance.

The remaining cases cited by the Government are similarly distinct from Sala's. *See, e.g., Klamath, supra*, 472 F. Supp. 2d 885 (holding that although the loss-generating transaction was described as part of a seven-year plan on paper, the "seven-year plan" was actually intended to be—and in fact was—concluded in its entirety by the end of the tax year in which the loss was generated); *see also Coltec, supra*, 454 F.3d 1340 (holding that although the loss-generating transfer of contingent asbestos litigation liabilities to Garrison—a Coltec subsidiary—in exchange for a $375 million note was done in conjunction with a legitimate business purpose transfer of management of asbestos claims, the transfer of management was "separate and distinct from the fact that Garrison took a managerial role in the asbestos liabilities, as demonstrated by the fact that Garrison managed another entity's asbestos liabilities . . . without actually assuming [its] liabilities" and therefore was not sufficiently linked with the transfer of liabilities for purposes of considering the transfer of management and liability as one transaction).

Unlike the phony seven-year plan in *Klamath*, the evidence here shows that not only the investors, but also the promoters and managers of the Deerhurst Program, intended the program to be long term. Andrew Krieger created a special entity—Beckenham Trading Company ("BTC")—that executed the trades on behalf of the Deerhurst Program. BTC had its own employees and its own independent infrastructure. The promoters of the Deerhurst Program, including Michael Schwartz and John Raby, were largely paid for their efforts out of the fees BTC generated from making trades. Likewise, Andrew Krieger received a large portion of his fees from BTC's profits. In 2000—the year in which Sala realized the tax loss—BTC generated no income. If the Deerhurst Program had been a quick in-and-out program, neither Krieger, Schwartz, nor Raby would have realized a significant return from the Deerhurst Program. As all three parties expressed their expectation of being paid for their work, it follows that all three expected and intended the Deerhurst Program to be ongoing. Accordingly, I find this case unlike those cited by the Government in support of its argument that the Deerhurst GP portion of the Deerhurst Program should be considered separately from the Deerhurst LLC portion of the Deerhurst Program for purposes of determining whether the loss-generating transaction was bona fide.

Instead, I find the facts here akin to those in *Salina Partnership LP v. Commissioner of Internal Revenue*, T.C. Memo. 2000-352 (2000). In *Salina Partnership*—a case addressing a question nearly identical to that presented in this section—the taxpayer invested in a long-term investment program that consisted of two distinct steps, one occurring at the end of 1992, and the other occurring from 1993 forward. Like this case, the 1992 portion lasted only a few days but yielded significant tax benefits. *See id.* at *9–11. While conceding the economic substance of the 1993-forward portion of the program, the Government claimed the 1992 portion was structured solely for the purpose of achieving tax benefits and therefore should have been considered a distinct transaction. *See id.* at *11. The Government argued the taxpayer never had any intent to achieve profits from the 1992 portion of the program, but always intended the invested funds to be immediately reinvested in the 1993 forward program. *See id.* Disagreeing with the Government's position, the Tax Court "decline[d] to analyze the economic substance of the disputed transaction by focusing solely on events occurring during the period December 28 through 31, 1992. Segregating FPL's investment in Salina into two parts, as respondent suggests, would violate the principle that the economic substance of a transaction turns on a review of the entire transaction." *Id.* at *13. The court was persuaded by the fact that the taxpayer—like Sala here, *see* Part VII, *infra*—conducted significant due diligence on the 1993 forward program before investing in the 1992 program and that a condition of investment in the 1992 program—like the investment in Deerhurst GP here—was the requirement that the liquidated 1992 funds be reinvested in the 1993 program. *See Salina P'ship*, T.C. Memo. 2000-352 at *13.

Accordingly, I find and conclude that—for purposes of determining whether the loss-generating portion of Sala's participation in Deerhurst was part of a bona fide transaction—the Deerhurst Program must be considered in its entirety from 2000 onward.

V. STEP TRANSACTION ANALYSIS

The Government argues that—for purposes of determining whether Sala suffered a deductible loss in 2000—the Deerhurst GP transactions should be collapsed into one transaction under the "step transaction doctrine." Under the Government's view, the steps Sala took in 2000 should be conceptually merged together so that Sala's purchase of the initial 24 options would—for purposes of calculating tax consequences—be converted to the $9 million dollar proceeds without the intervening loss-generating steps involving Solid Currencies. The issues involved in the application of the step transaction doctrine, especially with regard to taxpayer's intent, "are undeniably questions of fact." *See True v. United States*, 190 F.3d 1165, 1176 n.10 (10th Cir. 1999).

"Deciding 'whether to accord the separate steps of a complex transaction independent significance, or to treat them as related steps in a unified transaction, is a recurring problem in the field of tax law.' In search of an answer to this problem, courts utilize a variety of approaches, including a particular incarnation of the basic substance over form principle known as the step transaction doctrine. Simply stated, the step transaction doctrine provides that 'interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction.'" *See True, supra*, 190 F.3d at 1174 (quoting *Comm'r of Internal Revenue v. Clark*, 489 U.S. 726, 738 (1989); *King Enters., Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969)).

"Courts have developed three tests for determining when the step transaction doctrine should operate to collapse the individual steps of a complex transaction into a single integrated transaction for tax purposes: (1) end result, (2) interdependence, and (3) binding commitment. More than one test might be appropriate under any given set of circumstances; however, the circumstances need only satisfy one of the tests in order for the step transaction doctrine to operate." *True*, *supra*, 190 F.3d at 1174 (citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1522 (10th Cir. 1991)). While the Government tries to separate the Deerhurst GP transactions from the Deerhurst LLC transactions for purposes of the step transaction analysis, such a separation would run afoul of the rationale behind the step transaction doctrine in the first place: combining related steps into a single integrated transaction for tax purposes. Thus, as held above, the "complex transaction" examined in this section must necessarily include the entire Deerhurst Program from 2000 and beyond.

The end result test "amalgamates into a single transaction separate events which appear to be component parts of something undertaken to reach a particular result." *Kornfeld v. Comm'r of Internal Revenue*, 137 F.3d 1231, 1235 (10th Cir. 1998). Under this test, if the particular steps in a transaction are "merely the means to reach a particular result," I do not separate those steps, "but instead treat them as a single transaction." *See True*, *supra*, 190 F.3d at 1175. The taxpayer's subjective intent when entering into each step is especially important under this test. *See id.* Whether the taxpayer intended to avoid taxes, however, is not the relevant inquiry. *See id.* Instead, my focus is on whether—at the time each individual step was taken—each individual step had a purpose other than the achievement of the end result. *See id.* at 1175–77. Courts invoking the "end result" test generally find it applicable when the complex steps actually employed had little or no benefit over a more direct course of action. *See id.* at 1177; *Crenshaw v. United States*, 450 F.2d 472, 475 (5th Cir. 1971). If I apply the end result test, Sala's participation in the Deerhurst Program will be collapsed such that his initial investment in Deerhurst GP in 2000 will be considered for tax purposes as a direct investment in Deerhurst LLC in 2001.

Looking at the fact of this case, it is clear that the "end result" test should not apply. The intended end result of Sala's participation in the Deerhurst Program—aside from the tax benefits which are irrelevant to the "end result" inquiry—was to achieve significant returns from his Deerhurst LLC investments. The evidence presented at trial overwhelmingly shows that Sala was an extremely cautious investor who invested a great deal of time and energy carefully researching and choosing his investments. Sala's participation in the Deerhurst GP test period falls well within the realm of behavior one would expect from such an investor. Had the Deerhurst Program lost money during the Deerhurst GP test period comparable to the money lost in the Deerhurst LLC period—a phenomena not uncommon among hedge funds, according to Sala's credible testimony—Sala would have invested his money elsewhere. Accordingly, Sala's investment in Deerhurst GP was not a circuitous sojourn on the path to his investment in Deerhurst LLC, but was instead a checkpoint that protected him—albeit only to a small degree—from plunging headfirst into an uncertain five-year strategy. In that sense, the Deerhurst GP steps were not "taken for the purpose of reaching the ultimate result" of investing in Deerhurst LLC, but were steps taken for the purpose of protecting Sala from having to "reach the ultimate result"—investing in Deerhurst LLC—at all. *See Associated Wholesale Grocers*, *supra*, 927 F.2d at 1523 (citations omitted).

The "interdependence test" requires an inquiry into "whether under a reasonably objective view the steps were so interdependent that the legal relations created by one of the transactions seem fruitless without completion of the series." *Kornfeld*, *supra*, 137 F.3d at 1235. "Disregarding the tax effects of individual steps under this test is, therefore, 'especially proper where . . . it is unlikely that any one step would have been undertaken except in contemplation of the other integrating acts.'" *Associated Wholesale Grocers*, *supra*, 927 F.2d at 1523 (quoting *Kuper v. Comm'r of Internal Revenue*, 533 F.2d 152, 156 (5th Cir. 1976) (ellipsis in original)). If each individual step would not have been taken had the others not followed, therefore, the interdependence test requires those steps to be considered as one. *True*, *supra*, 190 F.3d at 1179.

Under the interdependence test, I "examine [the] tandem of transactional totalities to determine whether each step has a reasoned economic justification standing alone." *Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1247 (5th Cir. 1983); *see also True*, *supra*, 190 F.3d at 1178. The fact that there was a business purpose for each individual step is one indication that its formation was not interdependent with the subsequent steps. *See Associated Wholesale Grocers*, *supra*, 927 F.2d at 1527 n.15. As held in Part VI, *infra*, each individual step in the Deerhurst Program had a valid non-tax business purpose.

More important, the evidence presented at trial showed Sala invested in the Deerhurst Program for profit, *see* Part VII, *infra*, and each step of the transaction helped assure that goal. Sala could have achieved the tax loss without the use of Solid Currencies. Sala also could have achieved the tax loss without reinvesting in Deerhurst LLC. Each step Sala took leading to his eventual investment in Deerhurst LLC amounted to "the type of business activity one would expect to see in a bona fide, arm's length business deal between unrelated parties" and each makes objective sense standing alone without contemplation of the subsequent steps in the transaction. *See True*, *supra*, 190 F.3d at 1179. Most telling, the initial phases of the Deerhurst Program were structured such that Sala—as one investor did—could exit the program early before committing his full $9 million. Thus, as a matter of fact, each step did not lead "inexorably to the next." *See id.* Accordingly, it can hardly be said that each step of Sala's investment in the Deerhurst Program would be "fruitless" without the others and the interdependence test does not require the multiple steps in Sala's Deerhurst investment to be considered as one.

The "binding commitment" test collapses a series of steps into a single transaction where there was a binding commitment at the time the first step was entered into to also undertake a later step or series of steps. *See generally Comm'r of Internal Revenue v. Gordon*, 391 U.S. 83 (1968). The "binding commitment" test is seldom applied outside of the context of *Gordon*—wherein a corporate distribution was broken into a span of several years—and has generally been rejected in other contexts. *See Associated Wholesale Grocers*, *supra*, 927 F.2d at 1522 n.6. As this case does not concern the statutory language considered in *Gordon* concerning divisive reorganizations, I need not apply the test here. *See Security Indus.*, *supra*, 702 F.2d at 1245; *King Enters.*, *supra*, 418 F.2d at 517–18.

Accordingly, I find and conclude the step transaction doctrine does not apply here to merge Sala's purchase of the initial 24 options into his eventual investment in Deerhurst LLC without the intervening loss-generating steps involving Solid Currencies.

VI. WHETHER THE DEERHURST PROGRAM WAS A SHAM TRANSACTION

While 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, *Boulware* *v. United States*, 128 S. Ct. 1168, 1175 n.7 (2008), "sham transactions" are not recognized for tax purposes. *Keeler v. Comm'r of Internal Revenue*, 243 F.3d 1212, 1215 (10th Cir. 2001). "Sham transactions" generally fall into one of two categories. *James, supra*, 899 F.2d at 908 n.4. A "sham in fact" is a transaction that occurs on paper, but which never took place in reality. *Id.* The Government does not contend that the loss-generating investments at issue in this case were "shams in fact."

A "sham in substance" occurs when there is nothing of substance to be realized from a transaction apart from income tax savings. *James, supra*, 899 F.2d at 908. A transaction will be accorded tax recognition only if it has economic substance which is compelled or encouraged by business realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached. *Frank Lyon Co. v. United States*, 435 U.S. 561, 583–85 (1978). The analysis, therefore, requires both an objective inquiry into whether the transaction had economic substance—that is, a reasonable possibility of profits beyond the tax benefits—and a subjective inquiry into whether the taxpayer had a business purpose for engaging in the transaction other than tax avoidance. *See Jackson v. Comm'r of Internal Revenue*, 966 F.2d 598, 601 (10th Cir. 1992) (citing *Casebeer v. Comm'r of Internal Revenue*, 909 F.2d 1360, 1363 (9th Cir. 1990)); *Bohrer v. Comm'r of Internal Revenue*, 945 F.2d 344, 348 n.5 (10th Cir. 1991). It is not necessary for the Government to prove both inquiries. *James, supra*, 899 F.2d at 908–09. A finding that either a loss-generating transaction lacked objective economic substance or was not motivated by a non-tax business purpose is sufficient to find a transaction to be a sham. *See Keeler, supra*, 243 F.3d at 1220.

A review of the relevant case law makes clear that the line between the economic substance and business purpose inquiries is not a bright one, and that both inquiries have subjective and objective elements. *See Nickeson v. Comm'r of Internal Revenue*, 962 F.2d 973, 976 (10th Cir. 1992). Accordingly, I consider the economic substance of the Deerhurst Program and Sala's business purpose motivation together to determine whether the transaction had any practical economic effects other than the creation of income tax losses. *See Jackson, supra*, 966 F.2d at 601. I view the transaction as a whole, and each step—from commencement to consummation—is relevant. *See ACM P'Ship, supra*, 157 F.3d at 247.

A. Whether the Deerhurst Program had economic substance

Whether a claimed loss is deductible turns on "the objective realities of a transaction rather than the particular form the parties employed." *Boulware, supra*, 128 S. Ct. at 1175. It cannot seriously be doubted that the Deerhurst Program had the objective potential to be hugely profitable. Looking at the 24 basis-generating options—trades that Government expert Dr. DeRosa repeatedly referred to as "un-Kriegerlike" for their *low* potential to earn profits—the experts agreed that the contracts had the potential to earn profits of approximately $550,000—excluding a directional British pound-Japanese yen play—on an investment of approximate $728,000.

Accounting for the directional play, the profit potential was much higher. As Sala's expert Dr. Kolb and Dr. DeRosa both concluded, including the pound-yen play in the profitability calculation—due to its highly speculative nature—was inappropriate and I do not include it in my analysis here. I note, however, that the pound-yen directional play—the type of "occasional core position" Sala, Krieger, and White testified was typical of Krieger's trading technique—in fact returned over 500% of its cost in less than one month.

Dr. Kolb testified—and I agree—that the appropriate measure of comparison for determining profit from an investment is the cost of the investment, not the value of the undergirding account. Comparing the $550,000 profit, then, to the $728,000 cost, the 24 trades had a profit potential of approximately 75% in one year. Subtracting Krieger's 30% "incentive fee," 4% "management fee"—assuming the account was traded at a 4-to-1 notional value—and "mark-up fees" of 1.5 pips ($150) per million dollars in equity controlled, the profit potential of the 24 basis trades was approximately 45% per year as follows: $728,000 plus $550,000 yields approximately $1,278,000. $1,278,000 reduced by a 30% "incentive fee" on the $550,000 in profit yields $1,113,000. $1,113,000 reduced by a 4% "management fee" yields $1,068,480—a profit of over 46%. The inclusion a "mark-up fee" of 1.5 pips per million dollars roundturn has only a minor impact. Although no "mark-up fee" was actually charged on the 24 basis trades, a review of the Refco statements reveals that the $728,000 controlled $60 million in cash, leading to a "mark-up fee"—if it had been charged—of $9,000. This corresponds to a "mark-up fee" of approximately 1.2% of the $728,000. Subtracting the "mark-up fee" from the $1,068,480 yields $1,059,480—a profit, net of fees, of over 45%.

Had Krieger invested all of Sala's $9 million in similar "low profit potential" trades and reinvested the after-fee proceeds in similar trades, Sala's $9 million had the potential to exceed—albeit by a slender margin—the $60,449,984 claimed loss within the five years and two months dedicated to the combined Deerhurst Program. Although the possibility of achieving such maximum profits was small—based on Dr. DeRosa's estimate that the trades had, at most, a 50 percent likelihood of reaching maximum profitability in one year—the potential is still significant. If—as Dr. DeRosa repeatedly argued he should have—Krieger invested in higher profit potential trades, the likelihood of exceeding the $60 million tax loss could only increase.

Although Dr. DeRosa testified "it would be impossible to ever obtain" even a ten percent return using the investment strategy employed by Krieger in 2000, the actual results show DeRosa's testimony to be inaccurate in this regard. In fact, the results are even more impressive when calculated using the actual profits achieved from the basis trades. In 24 days, Sala's $728,000 investment yielded a profit of between $90,000 and $110,000—depending on which expert's opinion is believed—corresponding to a monthly return well over ten percent by either accounting. Annualized over the course of a 365-day year, this rate of return amounts to between approximately 550 and 780 percent. In light of the potential and actual profits arising from the Deerhurst Program, I find and conclude the program offered a reasonable opportunity for profits exclusive of the tax benefits and therefore possessed economic substance.

B. Whether Sala had a business purpose for structuring his investment in the Deerhurst Program other than tax avoidance

A taxpayer has a legal right to conduct his business so as to decrease—or altogether avoid—the amount of what otherwise would be his taxes. *Gregory v. Helvering*, 293 U.S. 465, 499 (1935). Accordingly, a tax-avoidance motive is not inherently fatal to a transaction. *See True*, *supra*, 190 F.3d at 1173 n.6. If a taxpayer chooses to conduct his business in a form that results in tax avoidance, however, he must choose a business structure that comprises a viable business entity that has a substantial business purpose or actually engages in substantive business activity. *See N. Ind. Pub. Serv. Co. v. Comm'r of Internal Revenue*, 115 F.3d 506, 511 (7th Cir. 1997).

The business purpose prong of the sham transaction inquiry is similar to the "primarily for profit" standard of 26 U.S.C. § 165, discussed at Part VII, *infra*. *See Friedman v. Comm'r of Internal Revenue*, 869 F.2d 785, 792 (4th Cir. 1989). Thus, the business purpose inquiry concerns the subjective motivations of the taxpayer when entering into the transaction. *See id.* Unlike the 26 U.S.C. § 165 inquiry, however, the business purpose inquiry is met by the taxpayer if he can show *any* business purpose for structuring his transactions other than tax avoidance. *See Frank Lyon Co.*, *supra*, 435 U.S. at 584; *Friedman*, 869 F.2d at 792; *see also Keeler*, *supra*, 243 F.3d at 1217. Whether the taxpayer had a business purpose other than tax avoidance can be determined by evidence demonstrating the taxpayer's subjective motivations or by an objective examination of the transaction. *See Friedman*, 869 F.2d at 792; *see also Keeler*, 243 F.3d at 1217.

As the business purpose inquiry is a factual question, the initial burden of production is on Sala to produce evidence sufficient to allow for judgment in his favor if not contradicted. *See* 26 U.S.C. § 7491. Sala met his burden of production at trial. While admitting the Deerhurst Program was structured in a way that provided significant tax benefits, Sala testified credibly at trial that each step of the program was structured to provide non-tax business benefits as well. Sala's testimony was supported by Michael Schwartz, Andrew Krieger, Martin White, Dr. Kolb, and documentary evidence. Accordingly, the burden is on the Government to show by a preponderance of the evidence that there was no business purpose to Sala's actions other than tax avoidance. The Government does not meet its burden.

1. Solid Currencies had a legitimate business purpose

Sala testified he believed contributing the loss-generating options contracts to an S corporation protected him from personal liability. Although Sala's attorney, Mr. Nemirow, expressed concerns that Solid Currencies was undercapitalized, he was satisfied by the opinion letter of Rosenman & Colin LLP concerning the liability issue—a letter Mr. Nemirow testified provided a "strong" and "unqualified" opinion regarding Sala's liability exposure under New York law.

The Government argues that the use of an S Corporation was intended to distinguish Sala's transaction from those listed in I.R.S. Notice 2000-44. The evidence presented at trial, however, showed that the use of an S Corporation was envisioned by the Deerhurst Program's promoters before Notice 2000-44 was issued. Moreover, Sala could have achieved the same tax benefits without the use of an S corporation by contributing the 24 options contracts directly to Deerhurst GP. This lends additional credibility to Sala's testimony regarding the business purpose of Solid Currencies. Accordingly, I find and conclude Sala's contribution of the loss-generating options contracts to Solid Currencies had a legitimate business purpose other than the creation of tax losses.

2. Deerhurst GP had a legitimate business purpose

A partnership will not be recognized for tax purposes if the partnership "is fictitious or if it has no business purpose or economic effect other than the creation of tax deductions." *DeMartino v. Comm'r of Internal Revenue*, 862 F.2d 400, 406 (2d Cir. 1988). In such cases, the basic inquiry is whether, all facts considered, the parties intended to join together as partners to conduct business activity for a purpose other than tax avoidance. *Comm'r of Internal Revenue v.*

Culbertson, 337 U.S. 733, 741 (1949); *ASA Investerings P'ship v. Comm'r of Internal Revenue*, 201 F.3d 505, 513 (D.C. Cir. 2000). The parties' "intention in this respect is a question of fact, to be determined from testimony disclosed by their 'agreement, considered as a whole, and by their conduct in execution of its provisions.'" *Culbertson*, 337 U.S. at 742 (citing *Drennen v. London Assurance Co.*, 113 U.S. 51, 56 (1885)).

Although there is no doubt the partners, including Sala, entered Deerhurst GP with an eye on tax benefits, there is likewise no doubt that they also entered Deerhurst GP with a good faith intent to join together for the purpose of investing in currency options and sharing in the profits, losses, and expenses. Further, there is no doubt that Deerhurst GP actually engaged in substantial business activity. Deerhurst GP bought and sold hundreds of options contracts—controlling billions of dollars in currency according to Dr. DeRosa—in its one month existence, and achieved substantial profits. These profits—as well as their related expenses—were divided among the partners based upon their partnership share.

As Sala and Krieger testified, contributing Solid Currencies' options to Deerhurst GP allowed for economies of scale, reduced transaction costs that could be spread among the various partners, reduced likelihood of human error, and better allocation of risk and exposure. Krieger testified that having a pool of funds in Deerhurst GP was preferable to numerous individual accounts in the test period because banks were generally not interested in trades amounting to less than $5 million. Although Sala's account—as well as Martin White's—was valued over $5 million, no other investor had an account approaching a similar value. Krieger and Sala both testified that larger trades were more attractive to banks and therefore afforded better liquidity and lower costs. Sala and Krieger testified as well that the larger pool of funds in Deerhurst

GP—as compared to the individual accounts—allowed for trading at a higher leveraged basis. As leverage increased, so did the potential for profit—or loss. This testimony was supported by the testimony of Sala's expert, Dr. Kolb, and I find it reasonable and credible.

Sala and Martin White both testified that the Deerhurst GP test period allowed investors to get comfortable with Krieger's operation and, as Sala put it, "make sure he didn't run off with my money." During the Deerhurst GP test period, Sala became acquainted with Krieger's back office operations and reporting, as well as Krieger's trading style and type of investments. Sala developed a working relationship with Krieger that culminated in Deerhurst adopting Sala's preferred reporting methods as its own—at least for the reports provided to Sala and Martin White.

Sala, Krieger, and Michael Schwartz testified that liquidating Deerhurst GP at the end of 2000 allowed for easier accounting and redistribution of the partnership assets. This testimony was confirmed by Dr. Kolb and I find it to be reasonable and credible. Sala and Krieger also testified that liquidation helped protect the parties against year-end volatility in the market.

The Government relied on the testimony of its expert Dr. DeRosa to show a lack of legitimate business purpose. Dr. DeRosa testified that Krieger's investment strategy was largely volatility-based, and therefore more profitable under volatile market conditions. While Dr. DeRosa's testimony was credible, it does not overwhelm the other valid business purposes for liquidating at the end of 2000, particularly in light of the fact that—as Dr. DeRosa noted in his expert report—the portfolio was profitable at the end of 2000, and actual profits could only be realized by selling the underlying contracts. In light of Krieger's understandable desire to start slowly in order to acclimate his clients to the novel world of foreign currency options trading, "cashing in" while the options were significantly profitable clearly served a reasonable and legitimate business end. Accordingly, I find the liquidation of the Deerhurst GP at the end of 2000 had a legitimate business purpose other than the creation of tax losses.

Viewing the Deerhurst GP transactions in their individual steps and in their entirety, therefore, I find and conclude Deerhurst GP was a bona fide partnership. Each transaction entered into by Sala with regard to the partnership—including Solid Currencies' contribution of the loss-generating options contracts to Deerhurst GP—and by the partnership with regard to Sala—including liquidating the options contracts at year's end—had a substantial business purpose other than the creation of tax losses.

3. The Deerhurst Program test period had a legitimate business purpose

The Government argues that the fact that Sala was committed to the Deerhurst Program if the Deerhurst GP made even a penny of profit conclusively shows Sala was only interested in a tax loss. I am unconvinced. As Krieger testified, the Deerhurst Program required a long term commitment in order to execute the foreign currency options trades profitably. Krieger had experienced difficulties with a prior client—Ross Capital—that chose to withdraw and then reinvest in the Deerhurst Program several times in 1998 and 1999. Accommodating short-term investors was excessively burdensome due to the large amount of currency controlled by the options. Krieger's testimony regarding his strong preference for long term investors was therefore credible. Whether or not a test period even occurred, it would not be unreasonable for Krieger to require a long term investment. The test period helped ensure any investors would remain invested. Also, as Krieger testified, allowing investors to start of with a smaller amount helped promote the program to those investors who would be uncomfortable jumping into the unfamiliar area of foreign currency options trading with a large up-front investment.

The Government also argues the test period could not have served as a model whereby Sala could become acquainted with Krieger's trading style because only $728,000 was actually invested, and the profit on the test account was—although the exact dollar amount is not clear—only about one percent of the $9 million. The Government's argument ignores the historic realities of the Deerhurst Program. As Sala, Krieger, White, and both experts testified, and as the documentary evidence clearly established, Krieger's trading style consisted mostly of lower risk, lower return investments coupled with occasional core positions betting on the direction of a particular currency's valuation. This is exactly what the 24 basis trades consisted of: five volatility-based sets of four options that had fixed risk/reward potential and two pairs of options with a directional basis. Moreover, the one percent return was comparable to the great plurality of monthly returns in the history of Deerhurst before 2000. Approximately fifty of the 107 months in which Deerhurst had been operational from 1991 to 2000 showed gains or losses of less than two percent. Thirty-six months—approximately one third of all months reported—showed gains or losses of less than one percent. Thus, contrary to the Government's position, Krieger traded in 2000 just as he had traded prior to 2000. No matter how "un-Kriegerlike" Dr. DeRosa believed the trades to be, the historical record of Krieger's actual trading patterns closely mimics that of the test period. Accordingly, I find and conclude the use of a test period had a legitimate business purpose other than the creation of tax losses.

4. The use of four-option sets had a legitimate business purpose

The Government presented expert testimony that Sala could have purchased essentially identical-risk options sets using "digital options"—options that are set at a specific price and either expire worthless or pay out a fixed amount. Dr. DeRosa's report notes that each of the four-option sets could be replaced with a cluster of 33 digital options—a total of 165 options achieving the same outcome as the 20 actually used—for a similar price. Using digital options, Sala would have had the same profit/loss potential, but controlled significantly less currency than the $60 million controlled by the 24 basis trades. Thus, using digital options, Sala would not have been able to achieve the $60 million tax loss. While this may be true, the law does not require Sala to have structured his affairs so as to maximize his tax burden. *See Helvering*, *supra*, 293 U.S. at 469. The Government presented no evidence that the option strategy actually employed by Krieger lacked a business purpose or was in any way unusual or suspect. Sala's expert, on the other hand, testified that digital options had significant disadvantages in that they were considered "exotic" options that were traded less frequently and therefore had less liquidity and higher transaction costs. I find this testimony to be credible. Accordingly, whether Sala could have achieved the same investment goal using digital options does not impact whether the purchase of the 24 basis options had a valid business purpose.

5. The Deerhurst Program, when viewed in its entirety, had a legitimate business purpose

Having determined that each step of Deerhurst Program in 2000 was structured in a way that had a valid business purpose above and beyond the creation of tax losses, I next look at whether—when viewed collectively—the Deerhurst Program had a valid business purpose. *See True*, *supra*, 190 F.3d at 1174. I apply the substance over form principle to prevent the true nature of the Deerhurst Program from being disguised by mere formalities. *See id.* In light of the Deerhurst Program's potential for significant profits and Sala's good faith and reasonable belief in and expectation of the program's profitability above and beyond the tax benefits, *see* Part VII, *infra*, I find and conclude the Deerhurst Program "considered as a whole" had a business purpose other than the creation of tax losses. *See id.* at 1177.

Accordingly, I hold Sala's investment in the Deerhurst Program was not a sham transaction.

VII. WHETHER SALA ENTERED INTO THE DEERHURST PROGRAM FOR PROFIT

Although the Deerhurst Program was not a sham transaction, Sala's losses are deductible from his ordinary income only if Sala satisfies the express statutory requirement of 26 U.S.C. § 165(c)(2) that the ordinary income deduction arises from a transaction entered into "for profit." *See Yosha v. Comm'r of Internal Revenue*, 861 F.2d 494, 499 (7th Cir. 1988); *Miller v. Comm'r of Internal Revenue*, 836 F.2d 1274, 1279 (10th Cir. 1988). The test of whether a taxpayer entered into a loss-generating transaction for profit requires a factual determination of the taxpayer's intentions when entering into the loss-creating venture. *See Miller*, 836 F.2d at 1279. If the taxpayer has a good faith belief that the venture will create a benefit in excess of the anticipated tax loss, the Government "allows the loss, because had the transaction been profitable as intended by the taxpayer, the government would have benefitted through increased taxable income." *Id.* at 1278–79. Even though the actual prospects of a profitable operation are minuscule, that is not conclusive in determining the taxpayer's purpose. *King v. United States*, 545 F.2d 700, 708 (10th Cir. 1976). Likewise, even if the venture is unprofitable in fact, the loss may still be deducted so long as it was reasonably expected to be profitable by the taxpayer. *See Miller*, *supra*, 836 F.2d at 1279. "What need be shown is that the taxpayer entered into the venture in good faith, for the purpose of making a profit." *King*, 545 F.2d at 708.

Under 26 U.S.C. § 7491, the initial burden of production is on Sala to produce evidence sufficient to allow for judgment in his favor if not contradicted. Sala met his burden of production at trial. Sala testified that he considered other investment programs, including BLIPS and OPIS, but determined these programs—unlike the Deerhurst Program—had little potential for long term profit. Sala testified he chose not to invest in these programs—but instead to invest in Deerhurst—based on his good faith belief—in light of the well-documented trading history of Krieger and Deerhurst—that the Deerhurst Program would be significantly profitable over its anticipated lifespan. Martin White testified similarly. I find this testimony to be credible. Both Sala and White also testified that profitability above and beyond the tax losses was more important than the tax losses themselves because the tax losses were speculative and somewhat dependent on the whims of the I.R.S. With this caveat in mind, Sala sought out an investment program that had what he calculated to be more than a 50% chance of being profitable over and above the tax losses. I find this testimony to be likewise credible. If no contrary evidence were submitted, Sala's credible testimony and supporting exhibits would—without regard to the judicial presumption of IRS correctness—be sufficient grounds to make a finding of fact that Sala entered into the Deerhurst Program with the ultimate objective of producing profits in excess of the tax losses. *Griffin*, *supra*, 315 F.3d at 1021. Accordingly, the burden of proof is on the Government under 26 U.S.C. § 7491 to show Sala did not enter into the Deerhurst Program with a primary profit objective. The Government fails to meet this burden.

In support of his assertion that he had a good faith belief the Deerhurst Program would be profitable, Sala testified extensively about his investigation of Andrew Krieger and the prior Deerhurst trading results. Sala's investigation revealed Krieger had a consistent record of profitability extending back to 1991, when the Deerhurst Program began. Krieger also had a reputation of being an aggressive foreign currency trader who was well known in financial circles for realizing a $228 million foreign currency exchange profit at Banker's Trust in 1987 at the age of 31. Krieger then went on to work for George Soros, another well-known foreign currency investor, where he achieved additional and significant profits. Sala contacted prior investors with whom Andrew Krieger had been associated—including Lehman Brothers and the Ross Perot Family Fund. These prior investors gave Krieger "glowing recommendations" and confirmed Krieger's reputation as a skilled and reputable investment manager with a history of making consistent and significant profits for his investors.

Before investing in the Deerhurst Program, Sala also reviewed Deerhurst's prior trading results from 1991 through 2000. Over this time period, Sala determined Deerhurst had an average annual return of between 16 and 18 percent net of fees on an unleveraged basis. An independent accounting firm, Julius D. Farber and Company, confirmed Deerhurst had an average annual return of 20.7 percent, net of fees, from 1995 through 1999. Sala applied these calculations and determined that Deerhurst had a significant potential for profit that reached as high as 89% per year net of fees if the performance was consistent with prior years—excluding 1991, 1999, and 2000—and the account was traded at a 4-to-1 leveraged basis.

Sala testified he calculated that if Deerhurst produced returns at the low end of its historic performance range—and Sala's account was unleveraged—Sala's investment net of fees would double in five years. Sala's 4-to-1 leveraged investment of $9 million would produce taxable income net of fees of approximately $58 million, yielding $26 million in taxes. If Deerhurst produced returns at the high end of its historic performance range, Sala's 4-to-1 leveraged investment would produce taxable income of over $100 million net of fees, yielding $46 million in taxes. Sala's testimony in this regard was corroborated by documentary evidence as well as by the testimony of Martin White and both Sala's and the Government's experts.

The Government argues that the fee structure imposed by Krieger and BTC was so high that it would have been impossible for Deerhurst LLC to ever have been profitable. Indeed, the fees in 2001 alone were as much as one quarter of the amount deposited. Determining Sala's profit motive by examining the outcome in hindsight, however, is inappropriate given the Tenth Circuit's instruction that profit motive be determined at the time the taxpayer enters into the transaction. *See King*, *supra*, 545 F.2d at 709 ("[T]hese transactions should not be viewed in hindsight. Rather, the proper focal point is at the time that King purchased the NOPIs.").

Sala testified extensively at trial that Krieger represented—and Sala reasonably believed—that BTC would actually reduce transaction costs. I find this testimony to be credible. Sala also credibly testified that he continued to receive reassurances from Krieger regarding the BTC fees throughout the life of the Deerhurst Program. The ostensibly cost-reducing effects of BTC were included in the Deerhurst promotional materials. Moreover, Sala's expert, Dr. Kolb, credibly opined that the BTC fees were not unreasonable, provided the returns net of fees were comparable to Deerhurst's historical performance. The Government cannot recast Sala's intent in light of what we all now know regarding Deerhurst's trading performance, but it must be determined at the time Sala entered into the Deerhurst transaction. The evidence makes clear that

Sala had ample reason to believe—and, in fact, did believe—the Deerhurst Program would be profitable, despite the fact that BTC would charge fees for executing the trades.

The Government also argues Sala's negotiation of a separate fee arrangement for himself and Martin White suggests Sala did not enter into the Deerhurst Program for profit. The standard fee agreement for investors in the Deerhurst program included (in addition to BTC's fees) a two percent annual management fee—calculated against the notional, *i.e.*, leveraged, value of the investment—plus an incentive fee of twenty percent of the profits. Sala sought a lower management fee of one percent. Krieger agreed to a lower management fee provided Sala would agree to an incentive fee of thirty percent. Sala admitted at trial that the arrangement he negotiated would result in less profits, but felt a decrease of the management fee accompanied by an increase of the profit share would both incentivise Krieger to ensure Deerhurst's profitability and help ease the pain should Deerhurst return lower than expected results. Both these considerations are reasonable and do not impact whether Sala had a good faith belief Deerhurst would be profitable above and beyond the tax losses. Such belief need not be absolute, as the Government's argument suggests.

In light of Krieger's and Deerhurst's past performance, Sala's testimony that he expected his investment in Deerhurst to be profitable above and beyond the expected tax loss was both reasonable and credible. Sala's extensive investigation and authentication—including first hand recommendations from prior investors—of Krieger's and Deerhurst's past performance, supports his testimony that he was seeking an investment that could achieve consistent and substantial profits. Sala's testimony that he considered other tax-advantaged investments before deciding on Deerhurst—but chose not to participate in these investments because of the low potential for significant profit—was also reasonable and credible. Sala's testimony was further supported by the testimony of Martin White and the documentary evidence presented at trial. Accordingly, I find and conclude Sala entered into the Deerhurst Program with a good faith belief that the venture would create a benefit in excess of the anticipated tax loss. *See Miller*, *supra*, 836 F.2d at 1279. Even though the Deerhurst Program was unprofitable in fact over the long term, the loss can still be deductible "because had the transaction been profitable as intended by the taxpayer, the government would have benefitted through increased taxable income." *Id.* at 1278–79.

VIII. WHETHER THE DEERHURST PROGRAM, AS EXECUTED, ALLOWED THE TAX LOSS

The Government argues that—even if the Deerhurst Program was not a sham transaction and was entered into primarily for profit—the Deerhurst Program was not executed in a manner that allowed the tax loss. Four issues are raised in this regard: (A) whether Sala's basis in Solid Currencies was properly calculated to include the $60 million value of the long options; (B) whether the $60 million loss appropriately reflected Sala's investment; (C) whether the long and short options could be considered separate instruments; and (D) whether Solid Currencies received property upon the liquidation of Deerhurst GP. I address each issue in turn.

A. Whether Sala's basis in Solid Currencies included the $60 million value of the long options under 26 U.S.C. §§ 351 and 358

When a taxpayer transfers property to a corporation in exchange for stock in the corporation, the taxpayer's basis in the stock received is generally equal to his basis in the property that was transferred to the corporation. *See* 26 U.S.C. § 358. Accordingly, no gain or loss is realized in such an exchange. *See* 26 U.S.C. § 351. If the taxpayer also receives money or property in addition to the stock, however, gain is recognized in amount equal to the amount of money and property received. *See* 26 U.S.C. § 351. If the transfer would result in a loss—such as when the taxpayer assumes a liability of the corporation—the loss is not passed to the taxpayer. *See* 26 U.S.C. § 351.

When a taxpayer transfers property in exchange for stock in a corporation and money or other property, the taxpayer's basis in the corporation is generally equal to the value of the property exchanged (a) decreased by the amount of money received by the taxpayer, the fair market value of any other property received by the taxpayer, and the amount of any loss to the taxpayer; and (b) increased by the amount which was treated as a dividend, and the amount of non-dividend gain to the taxpayer. *See* 26 U.S.C. § 358(a). Where the corporation assumes a liability of the taxpayer on the exchange, such assumption is treated as money received, *see* 26 U.S.C. § 358(d), unless the liability assumed is one that would give rise to a tax deduction when paid, *see* 26 U.S.C. § 357(c)(3), or unless the trade, business, or substantially all the assets with which the liability is associated are transferred to the party assuming the liability as part of the exchange, *see* 26 U.S.C. §§ 358(h)(2)(A) & (B); H.R. CONF. REP. 106-1033 at 1019 (2000).

In this case, Solid assumed all of the contingent obligations represented by the short positions held in Sala's personal account when Solid was formed. At the same time, Sala also transferred all of the long positions to Solid. As the evidence at trial showed, all assets held by Sala in his personal Refco account were transferred to Solid together. Accordingly, "substantially all of the assets" which were associated with the contingent obligations were transferred as part of the incorporation transaction. Under 26 U.S.C. § 358(h)(2)(B), therefore, Sala's basis in Solid was not reduced by the contingent liability value of the short options.

B. Whether Sala's $60 million loss from Solid Currencies was allowable under 26 U.S.C. §§ 465 and 1366

26 U.S.C. § 465 limits a taxpayer's deductions for losses from investment activities to the amount of money the taxpayer has at risk. Under § 465(b)(1)(A), a taxpayer's amount at risk includes "the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity." 26 U.S.C. § 465(b)(4), however, provides that "a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements." Case law from other circuits holds that offsetting options positions are not within the § 465(b)(4) exception. *See, e.g., Laureys v. Comm'r of Internal Revenue*, 92 T.C. 101, 131–32 (U.S. Tax Ct. 1989). I agree. Accordingly, Sala's amount "at risk" under § 465(b)(1)(A) included the $60 million in adjusted basis and the approximately $9 million in cash.

26 U.S.C. § 1366(d) limits the aggregate amount of losses a shareholder in an S corporation may deduct in a year to the adjusted basis of the shareholder's stock in the S corporation less the adjusted basis of any indebtedness to the S corporation. The Government argues the losses are limited to the amount of "investment" in the S corporation, and that such "investment" would be limited to the cost of the 24 options plus the $9 million in cash. In support, the Government cites cases holding that when a shareholder's basis in an S corporation is created using loans that did not have to be repaid or otherwise did not constitute an actual economic outlay on behalf of the shareholders, the shareholder's basis is not increased by the amount of the loans. *See, e.g., Estate of Leavitt v. Comm'r of Internal Revenue*, 875 F.2d 420 (4th Cir. 1989); *Pike v. Comm'r of Internal Revenue*, 78 T.C. 822 (U.S. Tax Ct. 1982).

To the extent these cases hold a phony loan does not constitute an "actual economic outlay," they are easily distinguished from this case. This case does not involve a phony loan. Each option was a real investment that had actual economic consequences associated with it. The options could be purchased, sold, and traded on the open market. They controlled the disposition of approximately $60 million in currency. Although Sala did not address this argument in his briefing or at trial, I hold the Government's claim—that the "actual economic outlay" requirement should alter the longstanding meaning of "adjusted basis" such that the rule regarding certain contingent liabilities, including short options, be disregarded—is unsupported and I reject it here. Sala's basis in Solid Currencies was properly determined under the rule that short options are not taken into account when calculating basis in acquired stock. Accordingly, Sala's basis—and potential for loss—in Solid Currencies was approximately $69 million.

C. Whether the long and short options can be considered separate instruments

In determining the tax consequences of the transfer of the long and short options, it must be determined whether the options should be treated as separate instruments or whether they consisted of integrated groups of offsetting options. If the options cannot be treated as separate instruments, they would be considered together and the value of the long options would be offset by the value of the short options for purposes of calculating basis. Thus, Solid Currencies' basis in Deerhurst GP would only amount to approximately $9 million—the offset value of the long and short options plus the cash contributed.

As a general rule, long and short options are considered separate instruments, even when purchased in offsetting pairs. *See Smith v. Comm'r of Internal Revenue*, 78 T.C. 350, 376 (U.S. Tax Ct. 1982). As Dr. Kolb testified, each of the 24 option positions was purchased as a separate contract, each was independently priced, and each could be transferred or assigned independently. Although Dr. DeRosa testified that executing the options contracts would be impractical due to the high cash outlay necessary, he conceded that—with $60 million in funding—the options could indeed be traded as separate instruments. Accordingly, I see no reason to depart from the longstanding rule and find that each of the 24 options contracts was a separate instrument.

D. Whether Solid Currencies received property upon the liquidation of Deerhurst GP

When a partnership makes a liquidating distribution, the basis of the distributed property in the hands of the partner is equal to the adjusted basis of the partner's interest in the partnership, less any money distributed. 26 U.S.C. § 732. Under 26 U.S.C. § 731, foreign currency is not considered "money" when distributed from an "investment partnership"—such as Deerhurst GP—that does not engage in a trade or business and whose assets consist substantially of marketable securities, including foreign currency and options contracts. 26 U.S.C. § 731(c)(3). Thus, any distribution of foreign currency or options from Deerhurst GP to Solid Currencies would be considered "property" to which Solid's adjusted basis—less the approximately $8 million in cash transferred—would attach. The parties dispute whether Deerhurst GP transferred any foreign currency or options to Solid Currencies at liquidation.

As a question of fact under 26 U.S.C. § 7491, the initial burden of production is on Sala to produce evidence sufficient to allow for judgment in his favor if not contradicted. Sala met his burden of production at trial. Sala testified that Solid Currencies received a cash transfer of $8 million as well as a put option and a spot option. This testimony was supported by documentary evidence and by the credible testimony of Dr. Kolb. If no contrary evidence were submitted, Sala's and Dr. Kolb's credible testimony and supporting exhibits would—without regard to the judicial presumption of IRS correctness—be sufficient grounds to make a finding of fact that Solid Currencies received both cash and property upon the liquidation of Deerhurst GP. Accordingly, the burden of proof is on the Government under 26 U.S.C. § 7491 to show Sala did not receive property upon liquidation of Deerhurst GP. The Government fails to meet this burden. Even if the burden were on Sala, however, the great weight of the credible evidence shows Solid Currencies received property upon liquidation of Deerhurst GP.

According to Dr. DeRosa, the Refco settlement statements show the disputed put option and spot trade were acquired by Deerhurst GP on December 20, 2000. Both were transferred to Solid Currencies on December 22, 2000, and paid for by the Solid Currencies Refco account. The Government claims this shows Solid Currencies received only cash, as the put option and spot trade were paid for by Solid Currencies and therefore not distributed as proceeds from Deerhurst GP's liquidation.

To the extent Dr. DeRosa relied on the Refco statements when formulating his position, his conclusions are suspect. Both parties presented evidence calling into doubt the accuracy of Refco's reports. Andrew Krieger testified extensively that Refco statements were notoriously unreliable and that Peter Molyneaux—who ran the back-office operations of Deerhurst—frequently found errors. This testimony is borne out somewhat by a review of the documents obtained from Molyneaux showing corrections. More important, Dr. DeRosa testified that Refco had known accounting problems that "very well may call into question Refco's customer statements." As the burden is on the Government as to this question of fact, I find the Refco statements were not entirely reliable.

Excluding the suspect Refco statements—which were certainly not conclusive on this point in any regard—the preponderance of the evidence shows that Solid Currencies did in fact receive the disputed put option and spot trade upon liquidation of Deerhurst GP. Documents prepared by Peter Molyneaux show both contracts were transferred on December 22, 2000. Sala and Krieger both testified this was their understanding of the events as well. Even Dr. DeRosa—the only witness testifying there was no transfer of property—stated in his expert report: "December 22, 2000. Deerhurst Investors GP transferred the Step 1 put option on the euro (EUR 26,004,030) to Solid Currencies. . . . Deerhurst Investors GP transferred the Step 1 spot trade to buy euros against dollars (EUR 10,401,612 against USD 9,423,860.47) to Solid Currencies." In light of this evidence, I find that Deerhurst GP transferred both the put option and spot trade to Solid Currencies on December 22, 2000.

This does not end the inquiry, however. Drs. Kolb and DeRosa disagreed whether the transfer of the put option and spot trade amounted to a transfer of "property" to which Solid Currencies basis in Deerhurst GP could attach. While the question whether what was transferred was "property" is ultimately a question beyond either's expertise—which Dr. Kolb was freely willing to admit, but Dr. DeRosa seemed reluctant to do—both experts testified that, at a minimum, what was transferred from Deerhurst GP to Solid Currencies was a reservation of the trades.

Dr. Kolb testified: "[I]n the context of the way financial markets work, when one engages in a trade and even gives a verbal utterance, one becomes obligated. And I say one is obligated . . . in that the other side very much expects the party to carry through with what they said they would do, and that if they don't carry through and actually consummate the transaction with cash flow, there will be very hard feelings and ultimately potentially serious consequences. And that's true, I think, in all financial markets." Dr. Kolb compared the options trading process to the commodities market depicted in movies and television by great numbers of traders waving their hands and giving signals to one another. At the end of each day, the "trades" agreed to in this frenetic flurry of hand waving are actually consummated and paid for. If a trader later disputes the terms of the trade, this can lead to arbitration or other legal consequences. Further, if a trader gains a reputation as one who does not follow through on his promises to buy or sell at a certain amount, he may be shunned by other traders and no longer be able to have his "reservations" accepted. Dr. Kolb testified that if the "reservations" agreed to by Deerhurst GP were not ultimately paid for—by Solid Currencies or otherwise—"then that is a serious breach of faith."

Dr. DeRosa testified initially that a reservation of a trade was no more like property than a reservation at a restaurant was like an actual meal. Thus, Deerhurst GP would not have a property interest in the put option and spot trade that could be transferred to Solid Currencies any more than a person who makes a reservation at a restaurant would have an obligation to pay for a meal eaten by someone who dines in the reserving person's stead. When pressed further, however, Dr. DeRosa admitted that—unlike a reservation at a restaurant—had the reserved trades not been paid for, Deerhurst GP would have liability exposure based on the value of the trades to the issuing bank. In light of both experts' agreement that a "reservation" includes a commitment to pay for the reservation, I find that—even if all that was transferred was a "reservation" and not an actual trade—the reservation constitutes "property" for purposes of §§ 731 and 732.

IX. WHETHER ANY ALLOWABLE TAX LOSS WAS RENDERED RETROACTIVELY DISALLOWED BY 26 C.F.R. § 1.752-6

Under 26 U.S.C. § 752, a partner's adjusted basis in a partnership is determined by a partner's contribution to the partnership. Under § 752(b), a partner must decrease his basis in the partnership to the extent that the partnership assumes the partner's individual liabilities. In 1975, the Government successfully argued before the United States Tax Court that obligations created by selling an option were too contingent to constitute liabilities under § 752 because no actual obligation on the part of the partnership existed unless and until the option was exercised. *See Helmer v. Comm'r of Internal Revenue*, T.C. Memo 1975-160 (1975). The taxpayer was therefore not allowed to increase his basis in the partnership and, as a result, owed additional taxes when the partnership made a distribution. The I.R.S. continued to successfully apply the rule of *Helmer* to increase partner taxation as late as 2000. *See Salina P'ship*, *supra*, T.C. Memo. 2000-352.

On June 24, 2003, the Treasury Department revised the regulations that govern the definition of "liability" for purposes of 26 U.S.C. § 752. *See* 26 C.F.R. §§ 1.752-1 through 1.752-7. For authority, the Treasury relied on Section 309 of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 at 2763A-638 (codified in 26 U.S.C. §§ 357 & 358) ("Section 309"). The new regulations—mimicking the definition of "liability" in Section 309—expanded the definition of "liability" under 26 U.S.C. § 752 to include "any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code." 26 C.F.R. §§ 1.752-1. Under the new regulations, a partner's basis in the partnership would generally be reduced by the value of the contingent liability. 26 C.F.R. § 1.752-6.

Where Section 309, however, carved out two exceptions—essentially maintaining the current state of the law as established in *Helmer*—when the trade or business or substantially all the assets with which the contingent liability is associated are transferred to the person assuming the liability as part of the exchange—*see* 26 U.S.C. § 358(h)(2)—26 C.F.R. § 1.752-6, added an "exception to the exception" for those cases where the exchange in question was a transaction described in I.R.S. Notice 2000-44. Notice 2000-44 describes a situation—similar to that at issue here—where a taxpayer purchases and writes options and contributes the options to a partnership, thereby creating basis in the partnership equivalent to the long options, but not offset by the short options. Under 26 C.F.R. § 1.752-6, if the transaction was one described in Notice 2000-44, contingent liabilities reduced the partner's basis in the partnership even if substantially all the assets with which the contingent liabilities were associated were also transferred simultaneously to the partnership. The Treasury made 26 C.F.R. § 1.752-6 retroactive, applying it to all assumptions of contingent liabilities occurring between October 18, 1999, and June 24, 2003. Sala claims the Treasury exceeded its authority in so doing. I agree.

A. Standard of review

The Tax Code—as amended in 1996—generally prohibits retroactive regulations. *See Klamath Strategic Inv. Fund, LLC v. United States*, 440 F. Supp. 2d 608, 620 (E.D. Tex. 2006); 26 U.S.C. § 7805. Under the amended version of § 7805, a regulation may be applied retroactively only in very specific enumerated circumstances. As applied to this case, a regulation may only be applied retroactively to the extent it was issued either to prevent abuse or pursuant to a legislative grant from Congress authorizing retroactive legislation. *See* 26 U.S.C. §§ 7805(b)(3) & (6). When making 26 C.F.R. § 1.752-6 retroactive, the Treasury claimed both that—under 26 U.S.C. § 7805(b)(6)—26 C.F.R. § 1.752-6's retroactivity was expressly authorized by Section 309(c) and that—under 26 U.S.C. § 7805(b)(3)—26 C.F.R. § 1.752-6 would prevent "the same types of abuses that section 358(h) was designed to deter." *See* 70 Fed. Reg 30335, 30337.

The standard of deference given to the Treasury's claim it is entitled to enact a retroactive regulation depends on whether the authorization to make the regulation retroactive is considered legislative or interpretive. If Congress has explicitly or implicitly delegated authority to an agency to issue a certain regulation, the regulation is considered a legislative regulation and is given controlling weight unless it is arbitrary, capricious, or manifestly contrary to the statute. *Chevron U.S.A., Inc. v. Natural Res. Defense Council, Inc.*, 467 U.S. 837, 844 (1984). "Review under the 'arbitrary and capricious standard' requires the court to decide whether the agency acted within the scope of its authority, whether the actual choice made was based on a consideration of the relevant factors, whether there has been a clear error of judgment, and whether the agency's action followed the necessary procedural requirements." *Webb v. Hodel*, 878 F.2d 1252, 1255 (10th Cir. 1989).

If a regulation is not "promulgated pursuant to authority Congress has delegated," it is considered an interpretive regulation and "the interpretation is 'entitled to respect' only to the extent it has the 'power to persuade.'" *Gonzales v. Oregon*, 546 U.S. 243, 256, 258 (2006) (quoting *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944)). "Because Congress has delegated to the Commissioner the power to promulgate 'all needful rules and regulations for the enforcement of the Internal Revenue Code,' 26 U.S.C. § 7805(a), [I] must defer to his regulatory interpretations of the Code so long as they are reasonable." *Cottage Sav. Ass'n v. Comm'r of Internal Revenue*, 499 U.S. 554, 560–61 (1991). Regulations are entitled to no deference, however, if they are inconsistent with congressional intent or if there are compelling indications that the regulations are wrong. *Webb, supra*, 878 F.2d at 1255. If I find the Treasury acted beyond its statutory authority by issuing a regulation that is "not in accordance with the law," or is "fundamentally at odds with the manifest congressional design," I therefore have the power to declare the regulation unlawful and set it aside. *See Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29. 41 (1983); *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 26 (1982).

B. Whether 26 C.F.R. § 1.752-6 is a legislative regulation

Section 309(d) explicitly provides for the retroactive application of rules issued under Section 309(c). Accordingly, if 26 C.F.R. § 1.752-6 was properly issued under Section 309(c), it is a legislative regulation and its retroactive application cannot be in dispute. To determine whether 26 C.F.R. § 1.752-6 "carries out the congressional mandate in a proper manner, [I] look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose." *Nat'l Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 477 (1979).

The first question is whether Congress has directly spoken to the precise question at issue. *Chevron, supra*, 467 U.S. at 842. If the answer to the first question is yes, that is the end of the matter "for the court, as well as the agency must give effect to the unambiguously expressed intent of Congress." *Id.* at 842–43. If the statute is silent or ambiguous, however, I defer to the Treasury's interpretation so long as it is based upon a "permissible construction of the statute." *Id.* at 843.

The statute upon which the Treasury ostensibly relied in issuing 26 C.F.R. § 1.752-6 is Section 309. Section 309 changed the law regarding contingent liabilities in the corporate context and required that, in most circumstances, contingent liabilities be taken into account to reduce shareholder basis in corporate stock. *See* 26 U.S.C. § 358(h)(3). In passing Section 309, Congress "was concerned about a type of transaction in which taxpayers seek to accelerate, and potentially duplicate, deductions involving certain liabilities." *See General Explanation of Tax Legislation Enacted in the 106th Congress*, JCS-2-01 at 154 (Joint Committee on Taxation, April 19, 2001). Congress was concerned that a taxpayer could transfer assets to a corporation, and the corporation could assume a contingent liability that would give rise to a deduction in a future taxable period. The shareholder could claim a basis in the stock equal to the basis of the assets he transferred to the corporation, unreduced by the contingent liability. Then, the shareholder could sell his stock in the corporation for a price that reflected the contingent liability. This would allow the shareholder to immediately "accelerate" a deduction that would otherwise be taken over time as the contingent liabilities were satisfied. Additionally, the corporation that assumed the contingent liability could take a deduction when it satisfied the liabilities, thus "duplicating" the deduction. In order to prevent such abusive acceleration and duplication of losses, Congress passed Section 309 in an attempt to "eliminate any loss on the sale of stock attributable to such liabilities." *Id.* The amendment was estimated to increase Federal fiscal year 2001 budget receipts by $13 million.

Section 309(c), codified in the notes to 26 U.S.C. § 358, authorized the Secretary of the Treasury to prescribe "comparable rules" which "provide appropriate adjustments under subchapter K of chapter 1 of the Internal Revenue Code of 1986 to prevent the acceleration or duplication of losses through the assumption of (or transfer of assets subject to) liabilities described in section 358(h)(3) of such Code . . . in transactions involving partnerships." Any regulations prescribed under 309(c) could be made retroactive to October 18, 1999.

The Government claims Section 309(c) authorizes the retroactivity of 26 C.F.R. § 1.752-6. Sala argues that the retroactivity of § 1.752-6 is not authorized by Section 309(c) because: (a) the rules set out for partnerships in § 1.752-6 are not "comparable" to the rules for corporations described in § 358(h) as required by § 309(c); (b) the rules do not address the "acceleration or duplication" of losses; and (c) the regulation does not apply to "liabilities described in section 358(h)(3)" of the Tax Code. I agree with Sala on each point.

1. Whether the rules set out for partnerships in § 1.752-6 are "comparable" to the rules for corporations described in § 358(h)

Section 309(c) authorizes the Treasury to issue "comparable rules" to be applied to transactions involving partnerships. Even a cursory look at the authorizing statute demonstrates § 1.752-6 is not a "comparable" rule. Applying 26 U.S.C. § 358(h) to the transaction at hand, the value of the options contributed by Sala to Solid Currencies must be disregarded when determining Sala's basis. While the contingent value of the short options contributed to Solid Currencies would generally be considered a liability under § 358(h)(3)—thereby reducing Sala's basis in Solid Currencies under § 358(h)(1)—§ 358(h)(2)(B) makes an exception where, as here, the associated short and long options are transferred together. Applying § 1.752-6, however, effectively eviscerates the outcome dictated by § 358(h)(2)(b). It does so by creating an "exception to the exception" provided by § 358(h)(2)(B) for transactions described in Notice 2000-44. When comparing Solid Currencies' basis in Deerhurst GP without the "exception to the exception"—*i.e.*, as dictated by the text of 26 U.S.C. § 358(h) if applied to partnerships—to the basis if the "exception to the exception" is applied, the former results in a basis of $69 million, while the latter results in a basis of $9 million. The results could hardly be less comparable.

2. Whether the rules in § 1.752-6 address the "acceleration or duplication" of losses

Congress authorized the Treasury to issue retroactive regulations "to prevent the acceleration or duplication of losses" through the assumption of contingent liabilities "in transactions involving partnerships." *See* Section 309(c). As stated in the committee report, a loss is "accelerated" when the taxpayer sells the stock in the transferee entity for a reduced price that reflects the losses that would otherwise be realized by satisfying the contingent liability in the normal course of business. *See General Explanation of Tax Legislation Enacted in the 106th Congress, supra.* A loss is "duplicated" when the transferee entity takes a deduction in addition to the deduction realized when the taxpayer sells his stock in the transferee entity at a loss. *See id.*

The transactions described in Notice 2000-44 do not involve accelerated or duplicated losses. The I.R.S. makes no reference to duplication or acceleration of losses in the notice, nor do the factual scenarios discussed therein lend themselves to duplicated or accelerated losses. The transactions described in Notice 2000-44 result in a single loss that occurs at a specific time: liquidation of the inflated-basis assets. Accordingly, to the extent the Treasury created an "exception to the exception" for Notice 2000-44 transactions, it exceeded the statutory grant of authority to "prescribe rules . . . to prevent the acceleration or duplication of losses . . . in transactions involving partnerships." *See* Section 309(c)(1); *see also Klamath*, *supra*, 440 F. Supp. 2d at 622.

3. Whether § 1.752-6 addresses "liabilities described in 26 U.S.C. § 358(h)(3)"

Section 309(c) authorizes the Treasury to prescribe regulations under subchapter K of the Tax Code—the subchapter on partnerships—addressing "the assumption of liabilities described in section 358(h)(3) . . . in transactions involving partnerships." Section 358(h)(3) provides that "for purposes of this subsection," the term "liability" includes contingent liabilities. The specific "subsection" referenced by § 358(h)(3) is § 358(h). Even if "subsection" is construed to mean all of § 358, § 358(h)(3) applies only to liabilities assumed in "an exchange or series or exchanges" to which "section 351, 354, 355, 356 or 361 applies"—all sections involving corporate exchanges. Thus, the language authorizing Treasury to issue regulations relating to "the assumption of liabilities described in section 358(h)(3)" can only be interpreted to relate to contingent liabilities assumed in a corporate exchange.

Because § 358(h)(3) applies only to liabilities that are assumed in an exchange or series of exchanges between a corporation and its shareholders, the language in § 309(c)(1) authorizing Treasury to issue regulations relating to "the assumption of liabilities described in section 358(h)(3) . . . in transactions involving partnerships" only authorized the Treasury to issue regulations involving transactions between a corporation and a partnership. The Treasury, in fact, did issue such a regulation addressing transfers by partners and partnerships to corporations in which the partners or partnerships are shareholders. *See* 26 C.F.R. 1.358-7. The regulation at issue here, however, applies to any transaction where a partner contributes property to a partnership in exchange for an interest in that partnership and where the partnership assumes a contingent liability of the partner—even if no corporation is involved.

By attempting to legislate rules for partner-partnership exchanges, § 1.752-6 is overly broad and exceeds the authority granted by § 309(c)(1). The overbreadth of § 1.752-6 is especially evident in light of the fact that § 358(h) is a corporate provision. *See Klamath*, *supra*, 440 F. Supp. 2d at 622. Had Congress intended to make a sea change in the law with respect to transactions between partners and their partnerships, it would have done so directly. It certainly would not have authorized Treasury to do so by regulation in a statute that fails to even mention § 752. Nothing in the Act or its legislative history suggest this was Congress's intent.

C. 26 C.F.R. § 1.752-6 cannot be applied retroactively to the Deerhurst Program

As 26 C.F.R. § 1.752-6 was not promulgated under an express grant of authority from Congress, it's retroactivity is not authorized by 26 U.S.C. § 7805(b)(6). This does not necessarily invalidate the regulation or its retroactivity, however. *See Klamath*, 440 F. Supp. 2d at 622. The regulation was ostensibly also issued pursuant to the Treasury's general grant of authority to issue retroactive regulations to prevent abuse, and its validity in serving this end—and therefore its accompanying retroactivity—may be analyzed under the antiabuse provision found in 26 U.S.C. § 7805(b)(3). Regulations issued under § 7805(b)(3) are necessarily interpretive. *See Klamath*, 440 F. Supp. 2d at 621.

The fair measure of deference to the Treasury's interpretive regulations administering the Tax Code is "understood to vary with circumstances, and courts have looked to the degree of the agency's care, its consistency, formality, and relative expertness, and to the persuasiveness of the agency's position." *United States v. Mead Corp.*, 533 U.S. 218, 228 (2001). Accordingly, the weight accorded an interpretive regulation depends on "all those factors which give it power to persuade, if lacking power to control." *Skidmore*, *supra*, 323 U.S. at 140.

The question of what constitutes "abuse" is not clarified by the statute. *See* Edward A. Morse, *Reflections on the Rule of Law and "Clear Reflection of Income": What Constrains Discretion?*, 8 CORNELL J.L. & PUB. POL'Y 445, 488 (1999) ("The scope of this exception is unclear, and it remains to be seen whether it will be exercised independently of Congress' power to authorize retroactive regulations."). The Joint Committee Report adds little other than stating the "abuse" envisioned is "abuse of the statute." *Background and Information Relating to the Taxpayer Bill of Rights*, JCX-15-95 at 22 (Joint Committee on Taxation, March 21,1995). Unfortunately, no court appears to have ruled on the scope of the § 7805(b)(3) exception.

As has been noted, "[i]t seems contrary to the purpose of the statute to allow the Secretary to promulgate retroactive regulations whenever it determines that something is 'abusive to the statute' without some check on the Secretary's ability to declare something abusive." *See* James Whitmire & Bruce Lemons, *The New Partnership Liability Regulations—Placing a Premium on Validity*, 606 PLI/TAX 229, 233 (2004). I need not decide this question here, however, because the regulation specifies the type of abuse it seeks to prevent: "the same types of abuses that [26 U.S.C.] section 358(h) was designed to deter." *See* 70 Fed. Reg 30335.

As the regulation is in fact contrary to 26 U.S.C. § 358(h), the Treasury's position is unpersuasive in the first instance. *See Mead Corp.*, *supra*, 533 U.S. at 228. A Treasury regulation that conflicts with the underlying statute is invalid, even if cast as an anti-abuse regulation. *See Microsoft Corp. v. Comm'r of Internal Revenue*, 311 F.3d 1178, 1189 (9th Cir. 2002); *see also Rasquin v. Humphreys*, 308 U.S. 54, 56 (1939) ("Whatever validity the . . . regulation . . . may have in its prospective operation, we think it so plainly in conflict with the statute as to preclude its application retroactively"). Even under the retroactivity-friendly Tax

Code prior to the 1996 amendments—*see, e.g.*, *Sec. Benefit Life Ins. Co. v. United States*, 517 F. Supp. 740, 756 (D. Kan. 1980) ("[T]he I.R.S. has broad power to promulgate rules and regulations with retroactive application. A presumption of retroactivity arises from 26 U.S.C. § 7805(b).")—the Treasury's retroactive application of a regulation could be considered an abuse of discretion if "the retroactive regulation alters settled prior law or policy upon which the taxpayer justifiedly relied and if the change causes the taxpayer to suffer inordinate harm." *CWT Farms, Inc., v. Comm'r of Internal Revenue*, 755 F.2d 790, 802 (11th Cir. 1985).

Treasury Regulation § 1.752-6 not only alters settled prior law—as the Treasury acknowledged, *see* 68 Fed. Reg. 37434, 37437 (June 24, 2003) ("The definition of a liability contained in these proposed regulations does not follow *Helmer v. Commissioner*, T.C. Memo 1975-160.")—it directly contradicts the underlying statutes—26 U.S.C. §§ 358 and 752—the abuse of which it supposedly prevents. As such, the regulation does not "protect" the statute from abuse, but rather amends the statute to reach an outcome different from—and contrary to—that the statute would require. Congress clearly intended to provide tax-protected status to the transactions described in 26 U.S.C. § 358(h)(2). By creating an "exception to the exception" for Notice 2000-44 transactions, the regulation overrides the statutory directive, rather that protects it.

The Government maintains that the anti-abuse provisions of § 7805(b)(3) should nonetheless apply, however, because "abuse is patent in Son of Boss tax shelters, which are designed to generate paper tax losses where no comparable economic losses have occurred." *Cf. Cemco Investors, LLC v. United States*, 515 F.3d 749, 751 (7th Cir. 2008) ("The Commissioner has a statutory power to disregard transactions that lack economic substance."). Although

Congress has delegated to the Treasury the general authority to make rules carrying the force of law, *see Mead*, *supra*, 533 U.S. at 226–27, the authority to make such rules retroactive is limited. The Treasury is only entitled to make regulations retroactive to prevent "abuse of the statute," which this regulation clearly does not do. Moreover, the facts show Sala's participation in the Deerhurst Program was a genuine investment transaction that possessed economic substance and was entered into for the purposes of realizing profits above and beyond the tax losses. Because Sala's investment in the Deerhurst Program was not abusive, it is immaterial whether other transactions of the general type he entered into were abusive.

Cemco does not counsel a contrary conclusion. Initially, I note an opinion of the Seventh Circuit is not controlling on this Court. Further (in an opinion curiously lacking substantive analysis) the *Cemco* court did not analyze whether the Treasury exceeded its statutory authority in promulgating 26 C.F.R. § 1.752-6. The *Cemco* court based its conclusion regarding the regulation's retroactivity solely on the fact that the retroactive date—October 18, 1999—was the same as the date authorized by Section 309. *Cemco*, 515 F.3d at 752. If the question presented in this case was whether the retroactive date in the regulation was a valid one, *Cemco*'s holding in this regard would have some persuasive relevance. As to the validity of the regulation's retroactivity at all, however, it has none.

In light of my conclusion that 26 C.F.R. § 1.752-6 is contrary to the statutes it supposedly protects from abuse, I accord no deference to the Treasury's claim that 26 C.F.R. § 1.756-2 was properly issued under Section 309—and properly made retroactive under 26 U.S.C. § 7805. Instead of protecting the statutes from abuse, Treasury's attempt to legislate an exception to the statutory exception to be applied only in Notice 2000-44 transactions was an obvious effort to bootstrap the government's litigating position with respect to so-called "Son of Boss" cases. Indeed, the day following the promulgation of the regulations, Treasury told its attorneys to use the newly enacted regulations as a principal ground to challenge taxpayers' claimed losses. *See* Chief Counsel Notice CC-2003-020, released June 25, 2003. Such a procedure is generally improper, and such make-weight regulations are frequently disregarded by the courts—*see, e.g., Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 213 (1988) ("Deference to what appears to be nothing more than an agency's convenient litigating position would be entirely inappropriate."); *Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300, 303 (2d Cir. 1971) ("[T]he Commissioner may not take advantage of his power to promulgate retroactive regulations during the course of a litigation for the purpose of providing himself with a defense.")—if they do not reflect a "fair and considered judgment on the matter in question." *See Long Island Care at Home, Ltd. v. Coke*, 127 S. Ct. 2339, 2349 (2007). This is not a case like the one in *Long Island Care* where a regulation was intended to settle a question the agency had "struggled" with for years. To the contrary, the regulation sought to reverse a policy the Treasury had relied upon—whenever such reliance inured to its benefit—since 1975.

Accordingly, I hold 26 C.F.R. § 1.752-6 to be unlawful and set it aside. Even if 26 C.F.R. § 1.752-6 was properly issued—that is, even if the regulation was not contrary to the underlying statutes—the Treasury would still lack the authority to make the regulation retroactive under the anti-abuse provision of 26 U.S.C. § 7805(b)(3). Without retroactive application, 26 C.F.R. § 1.752-6—being issued many years after Sala entered into the Deerhurst Program—has no bearing on this case.

X. WHETHER THE GOVERNMENT IS ENTITLED TO OFFSET ANY EXCESS INTEREST PAYMENTS WITH AN ACCURACY-RELATED PENALTY

This Court has previously ruled Sala was entitled to summary judgment on his entitlement to a refund of a portion of the interest he paid on his 2000 taxes [Docket # 154]. The Government seeks to offset this refund with an accuracy related penalty owed but not assessed by the I.R.S. pursuant to 26 U.S.C. § 6662.

The I.R.S. may only apply such a penalty if there is an "underpayment" of taxes. *See* 26 U.S.C. § 6662. Having determined that Sala was entitled to the approximately $60 million loss claimed in 2000—and in the absence of any evidence of "underpayment" of some other variety—I conclude the Government is not entitled to an offset.

Even if Sala did underpay his 2000 taxes, however, the Government is not entitled to a penalty if Sala filed a "qualified amended return." 26 C.F.R. § 1.6664-2(c)(2). An amended return is not a qualified amended return if it was filed after the commencement of an investigation of "any person described in section 6700(a) . . . concerning an examination of an activity described in section § 6700(a) with respect to which the taxpayer claimed any tax benefit on the return directly or indirectly." 26 C.F.R. § 1.6664-2(c)(3)(ii) (2003) (this rule was amended in 2005; I cite here to the rule in effect in 2002 and 2003). Section 6700(a) imposes penalties on anyone who "organizes (or assists in the organization of)" an abusive tax shelter.

The Government argues Sala's amended return was not qualified because KPMG—an alleged "promoter" of Deerhurst, and a red herring in this case—was under investigation prior to Sala's filing of his amended return. As I previously held in my July 3, 2007, Order, KPMG was indeed under investigation for promoting abusive tax shelters prior to when Sala filed his amended return on November 18, 2003. While the Government admits this investigation did not include Deerhurst *per se*, it claims the investigation of KPMG involved tax shelter activities related to Deerhurst.

The relevant inquiry, however, is not whether KPMG was contacted regarding transactions similar to Deerhurst, but whether KPMG was contacted regarding Deerhurst itself. Under 26 C.F.R. § 1.6664-2(c)(3)(ii), an amended return is not "qualified" if filed after a "person" described in 26 U.S.C. § 6700 is contacted regarding a transaction described in § 6700 "with respect to which the taxpayer claimed any tax benefit." The only transaction with respect to which Sala "claimed any tax benefit" in 2000 was the Deerhurst Program. No evidence was presented at trial showing KPMG was contacted regarding Deerhurst prior to November 18, 2003. Accordingly, the Government fails to make a *prima facie* case that penalties should apply.

XI. CONCLUSION

In summary, I find and conclude: (1) Sala's participation in the Deerhurst Program possessed a reasonable possibility of profits beyond the tax benefits, was entered into for a business purpose other than tax avoidance, and was motivated by a desire for profits above and beyond the tax benefits sought; (2) Sala's basis in Solid Currencies was approximately $69 million—the value of the long options contributed plus the cash contributed—and Solid Currencies' basis in Deerhurst GP was an identical amount; (3) the 24 options contracts contributed by Sala to Solid Currencies and by Solid Currencies to Deerhurst GP were separate financial instruments; (4) Solid Currencies received property upon the liquidation of Deerhurst GP; (5) the Treasury exceeded its authority when issuing 26 C.F.R. § 1.752-6(b)(2); (6) the Treasury exceeded its authority when making 26 C.F.R. § 1.752-6 retroactive; (7) Sala filed a qualified amended return on November 18, 2003; and (8) the Government is not entitled to offset any excess interest payments made by Sala with an accuracy-related penalty.

Accordingly, IT IS ORDERED that judgment shall enter in favor of Carlos Sala and Tina Zanolini-Sala and against the Government on all claims and counterclaims. As agreed to by the parties in the Amended Pretrial Order, the parties shall submit a joint stipulation as to computation of Sala's refund, plus applicable interest and costs, within 30 days of the issuance of this Order.

Dated: April __22__, 2008.

BY THE COURT:

s/Lewis T. Babcock
Lewis T. Babcock, Judge

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO
LEWIS T. BABCOCK, JUDGE

Civil Case No. 05-cv-00636-LTB-KLM

CARLOS E. SALA, and
TINA ZANOLINI-SALA,

Plaintiffs,

v.

UNITED STATES OF AMERICA,

Defendant.

JUDGMENT

PURSUANT TO and in accordance with the Memorandum Opinion and Order entered May 1, 2007 by the Honorable Lewis T. Babcock, United States District Judge, it is

ORDERED that Plaintiffs' motion for partial summary judgment on the interest suspension issue is granted.

This matter came on for a bench trial before the Court on March 10, 2008, the Honorable Lewis T. Babcock, United States District Judge, presiding.

PURSUANT TO and in accordance with the Findings of Fact, Conclusions of Law and Order entered by the Honorable Lewis T. Babcock, United States District Judge on April 22, 2008, it is

ORDERED that judgment is entered in favor of Plaintiffs Carlos Sala and Tina Zanolini-Sala and against the Defendant United States of America on all claims and counterclaims.

PURSUANT TO and in accordance with the Joint Stipulation Regarding Tax, Interest, and Taxable Costs, filed on May 22, 2008,

Judgment is entered in favor of Plaintiffs Carlos Sala and Tina Zanolini-Sala and against the Defendant United States of America in the amount of $37,049,146.99 in tax and interest computed through May 22, 2008, plus interest subsequent to that date as provided by law. It is

FURTHER ORDERED that Costs are awarded as set forth in the Joint Stipulation Regarding Tax, Interest, And Taxable Costs, filed May 22, 2008.

Dated at Denver, Colorado this 27th day of May 2008.

APPROVED:

s/Lewis T. Babcock
Lewis T. Babcock, Judge
United States District Court

FOR THE COURT:

GREGORY C. LANGHAM, CLERK

By s/Edward P. Butler
Edward P. Butler,
Deputy Clerk

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO
LEWIS T. BABCOCK, JUDGE

Civil Case No. 05-cv-00636-LTB

CARLOS E. SALA, and
TINA ZANOLINI-SALA,

Plaintiffs,

v.

UNITED STATES OF AMERICA,

Defendant.

ORDER

This action concerns a claim by Plaintiffs Carlos E. Sala and Tina Zanolini-Sala (referred to herein as "Sala," since Tina Zanolini-Sala is a named plaintiff only because the Salas filed a joint tax return) for a refund on Sala's 2000 federal taxes. An eight-day trial to the Court was held commencing March 10, 2008, and concluding March 19, 2008. The two claims at issue were Sala's entitlement to a refund of the taxes, penalties, and interest he paid on his 2000 income and—to the extent any refund was due Sala on putatively "excess" interest—the Government's entitlement to an accuracy-related penalty owed, but not assessed. After a review of all the evidence presented both at trial and by deposition, I found in favor of Sala and against the Government on all claims and counterclaims on April 22, 2008 **[Docket # 246]**. The Government now moves for a new trial **[Docket ## 258, 259]**. Oral argument would not materially assist the determination of this motion. After consideration of the motion, the papers, and the case file, and for the reasons stated below, I DENY the Government's Motion for a New Trial [**Docket # 258**].

I. BACKGROUND

The facts of this case are well-summarized in my April 22, 2008, Findings of Fact, Conclusions of Law, and Order [**Docket # 246**] and I need not repeat them here. Relevant to this motion is the videotaped deposition testimony of Andrew Krieger—the principal owner and manager of the Deerhurst foreign currency investment program ("Deerhurst Program") at issue in this case—played over three days beginning March 11, 2008, and concluding March 13, 2008.

Before Krieger's deposition was played, I heard argument from the Government objecting to the use of Krieger's video deposition—which was taken on October 26 and 27, 2006, and April 17, 2007—on the basis of a February 27, 2008, letter from Krieger's counsel, Jay Fischer ("Fischer letter") [**Docket # 229 p. 9**]. The Fischer letter stated Krieger—subsequent to the taping of his deposition—was questioned extensively by the Government in regards to a criminal investigation in another matter. The Fischer letter stated:

> Having had some time to consider questions raised in the Sala deposition, it appears Mr. Krieger provided information to the United States government that may be inconsistent with information provided in the depositions. For example, it is now Mr. Krieger's view, based upon his review and reevaluation of the circumstances, that the programs in which Mr. Sala was involved were essentially tax driven, as opposed to profit driven. This, of course, does not change any of Mr. Krieger's testimony as to what Mr. Sala told Mr. Krieger regarding his (Sala's) motivation nor does it affect any testimony provided in the deposition as to the lack of any knowledge on Mr. Krieger's part as to the ultimate utilization by Sala of any gains and/or losses in the preparation of any tax returns.

After reviewing the Fischer letter and considering the arguments made by counsel for both parties, I concluded the Fischer letter—which clearly was hearsay at any rate—amounted to no more than speculation and was ambiguous as to which portions of Krieger's deposition, if any, were "inconsistent." I also noted that the circumstances leading to the letter were troubling, both because the letter was procured as the result of a criminal investigation unrelated to this case and because the eve-of-trial timing of the letter was suspect in light of the Government's repeated efforts to delay, postpone, stay, and otherwise put off the trial of this case. Accordingly, I overruled the Government's objection and proceeded with the video.

The Government now provides a sworn statement from Krieger dated May 22, 2008, recasting portions of his videotaped deposition testimony as "false, misleading and incomplete." [**Docket # 260-4**]. Krieger states he knew his deposition to be "false, misleading and incomplete" before the Fischer letter was sent, but he "was not willing to be re-interviewed by the parties or provide sworn testimony in this case at that time because [his] truthful statements would have incriminated [him]." Krieger states he informed Fischer of both specific and possible inconsistencies and these inconsistencies were noted in a letter—undisclosed to the Court until now—sent to Sala and the Government on March 12, 2008. At that time, however, Krieger was still unwilling to be re-interviewed or provide sworn testimony.

On May 21, 2008—after entry of my Findings of Fact, Conclusions of Law, and Order in this case, but before the May 27, 2008, entry of Judgment—Krieger executed a non-prosecution agreement with various Government offices—including the United States Attorney's Office ("USAO"), the Tax Division of the United States Department of Justice, and the Internal Revenue Service—that required him "to provide truthful information and testimony about [his] activities involving tax shelters, and . . . provides that if [he] do[es] so, [he] will not be prosecuted for those activities or for the false testimony [he] gave in this matter." Krieger stated he was advised not to provide any sworn testimony until the non-prosecution agreement was signed, and, in any event, he was living in Dubai at least from August 2007 through the date of the trial.

Addressing the "false, misleading and incomplete" portions of his deposition, Krieger now asserts the following is the actual "truthful information" regarding the Deerhurst Program—referring to the basis-generating trades as the "tax trades":

a. The primary purpose of the tax trades was to generate tax losses, not positive economic returns. The tax benefits were not "incidental." But for the need to generate tax losses, Krieger would not have made the tax trades. Krieger also had predetermined to sell the tax trade positions by year end regardless of market conditions;

b. Krieger was told by Michael Schwartz—a promoter of the Deerhurst Program—that he was to purchase roughly equal amounts of long and short options with premiums approximately equal to the tax losses sought in order to effectuate the tax losses. Krieger would not have entered into trades with the face amounts of the tax trades but for the need to purchase trades with premiums equal to the tax losses sought;

c. If Krieger had charged Sala the transaction costs normally charged by Refco, the trades would have been cost prohibitive. Krieger utilized his Beckenham Trading Company to assume the risk of the trades in order to decrease the cost to the investors and to help ensure profitability by year's end;

d. Krieger could not have separated the long and short options due to the size of the premiums relative to the amount of capital in the account;

e. The test period in 2000 was not a realistic test of Krieger's trading program and was not intended to acclimate investors to foreign exchange trading, but was intended only for disguising the tax benefits;

f. The structure of the Deerhurst Program—including the use of an S corporation and a general partnership—was not designed for any purpose other than the creation of tax losses. The Deerhurst Program was executed in a series of predetermined series of steps orchestrated by Mr. Schwartz for the purpose of creating a tax loss;

g. There was no business purpose for liquidating the test accounts at the close of 2000 other than the generation of tax losses. Absent consideration of the tax losses, the positions in the test accounts would not have been prematurely unwound;

h. Krieger was an investor in the Deerhurst Program and his primary motive for so participating was to generate a 2000 tax loss.

Krieger also asserts he "purposely avoided all discussions of tax matters and purposely downplayed the tax motives behind the tax trades or the 'investment program.'" He claims he was "aware that the primary motivation for entering into these tax trades and the 'investment program' was to generate tax savings."

In light of Krieger's May 22, 2008, declaration, the Government now seeks a new trial under FED. R. CIV. P. 59(a), or, in the alternative, amended findings and conclusions under FED. R. CIV. P. 52(b) and/or 59(e).

II. NEW TRIAL UNDER FED. R. CIV. P. 59(a)

A party seeking a new trial under Rule 59(a) on the basis of newly discovered evidence must show: (1) the evidence was newly discovered since trial; (2) the moving party was diligent in discovering the new evidence; (3) the newly discovered evidence is not merely cumulative or impeaching; (4) the newly discovered evidence is material; and (5) that a new trial—with the newly discovered evidence—would probably produce a different result. *Joseph v. Terminix Int'l Co.*, 17 F.3d 1282, 1285 (10th Cir. 1994).. On such a motion, if the Court is convinced the prior judgment was based on manifest error of law or fact, it may open the judgment, take additional testimony, amend or make new findings of fact and conclusions of law, and/or direct entry of a new judgment. *Lyons v. Jefferson Bank & Trust*, 793 F. Supp. 989, 992 (D. Colo. 1992). If the Government, as the moving party, cannot meet each of the five inquiries, however, relief under Rule 59(a) is not available.

Although the Government spends the majority of its briefing arguing that the "evidence" is "newly discovered"—a contention that strains credulity in light of the fact that the Government received an itemized letter delineating the content of Krieger's May 22, 2008, declaration as early as March 12, 2008—the Government spends a cursory three sentences arguing the "newly discovered evidence" is, in fact, "new"—that is, that the "newly discovered evidence" is not merely cumulative or impeaching. The Government's neglect in this regard is certainly understandable: a comparison of Krieger's May 22, 2008, declaration with the evidence introduced at trial shows that none of the statements in the former but one—that involving the separability of the long and short options—actually concerns "new" information.

BLACK'S LAW DICTIONARY defines "impeach" as "[t]o dispute, disparage, deny, or contradict" and "impeachment" as "[t]o call into question the veracity of a witness." BLACK'S LAW DICTIONARY 678 (5th ed. 1979). While the Government argues its "intention is not to impeach Mr. Krieger, but rather to present truthful testimony about what transpired in Plaintiff's tax shelter," it cannot escape the fact that many of the statements made in Krieger's May 22, 2008, declaration directly dispute, deny, or contradict—and therefore, by definition, impeach—his video deposition. These statements are: (1) the primary purpose of the tax trades was to generate tax losses, not profits; (2) the purpose of the test period was to generate tax losses, not to acquaint Sala and other investors with the program; (3) the structure of the Deerhurst Program that gave rise to the tax losses had no purpose other than the creation of tax losses; (4) there was no purpose in unwinding the tax trades at the end of 2000 other than achieving tax losses and the positions would not have been unwound prematurely but for the tax losses; and (5) Krieger's primary purpose in participating in the Deerhurst Program was to generate a tax loss in 2000.

"Cumulative evidence" is defined as: "Additional or corroborative evidence to the same point. That which goes to prove what has already been established by other evidence." BLACK'S LAW DICTIONARY 343 (5th ed. 1979). The non-impeaching statements in the May 22, 2008, declaration—with the exception of the one "new" assertion—are cumulative with evidence already in the record. As I noted during the course of trial and in my April 22, 2008, Findings of Fact, Conclusions of Law, and Order ("Order"), the evidence showed: the use of roughly-equivalent long and short options was intended to generate tax losses for the Deerhurst Program participants (Trial Transcript p. 594; Order pp. 3, 29); the Deerhurst GP account was intended from inception to be liquidated at the end of 2000 (Order p. 9); the face values of the tax trades were intentionally structured to mirror the expected tax loss (Order p. 9); the Deerhurst Program was intended to have significant tax benefits (Order pp. 16, 23); Beckenham Trading charged no fee for executing the tax trades (Order p. 21); the fees charged by Beckenham Trading in subsequent years were substantial (Order p. 33); had Krieger charged Sala comparable fees for executing the tax trades, it would have significantly reduced the economic feasibility of the Deerhurst Program (Order p. 33); and the structure of the Deerhurst Program was ordered around a series of predetermined steps orchestrated by Mr. Schwartz for the purpose of creating a tax loss (Order pp. 3, 8–10, 16–18, 23–26, 29). Accordingly, as to each assertion in Krieger's May 22, 2008, declaration—other than that involving the separability of the long and short options—the third prong of the Rule 59(a) inquiry is not met.

As to the one non-cumulative and non-impeaching statement in Krieger's May 22, 2008, declaration—that Krieger could not have separated the long and short options due to the size of the premiums relative to the amount of capital in the account—the inclusion of this testimony would not have altered the outcome of this case. The Government argued this position strenuously at trial, but even the Government's own expert—self-proclaimed "government contractor" Dr. DeRosa—conceded that separating the long and short options was possible, although impractical or improbable (Trial Transcript pp. 687–88, 823–30). Even if I considered Krieger's "new" testimony to be credible—which seems unlikely due to the suspect circumstances under which his "examples of truthful testimony" now come before me—its inclusion would not produce a different result.

I am also unconvinced that the Government was diligent in attempting to discover the "new" evidence. "The intent of the diligence requirement is to insure litigants do not 'hold back' evidence so as to be granted a new trial if the first trial is lost." *Graham v. Wyeth Labs.*, 906 F.2d 1399, 1417 (10th Cir. 1990). Krieger's declaration states he met with the USAO sometime before leaving for Dubai in August 2007, and informed the USAO that parts of his deposition were "false, misleading, and incomplete." Nonetheless, the Government now says it was unable to procure a specific recantation until May 22, 2008—a month after my Findings of Fact, Conclusions of Law, and Order was issued and (conveniently) the same day as the deadline for the parties to stipulate to final judgment. This is so—the Government would have me find—despite the Government's awareness of the detrimental nature of the deposition testimony as early as October 2006 and as late as April 2007? This is so despite the Government's demonstrated power to wield the Sword of Damocles to secure a non-prosecution agreement? I think not.

Rather than showing diligence, the timing of this "new" evidence instead implies a deliberate attempt on the part of the Government to further delay and derail this case for tactical gain. Likewise, the Government's mere fig leaf of explanation as to why it did not disclose the March 12, 2008, letter to this Court—despite the fact that the Government was in receipt of the letter while Krieger's video testimony was ongoing—does not show diligence. Considering the timing of the present motion, the circumstances surrounding and content included in Krieger's May 22, 2008, declaration, and the Government's continued efforts to delay the ultimate resolution of this case, I am convinced a new trial under Rule 59(a) is—to say the least—inappropriate.

III. AMENDMENT UNDER FED. R. CIV. P. 52(b) OR 59(e)

A Rule 52(b) or Rule 59(e) motion to alter or amend a judgment should be entered only to correct manifest errors of law or to present newly discovered evidence. *Phelps v. Hamilton*, 122 F.3d 1309, 1324 (10th Cir. 1997); *Lyons v. Jefferson Bank & Trust*, 793 F. Supp. 989, 990–91 (D. Colo. 1992). Where—as here—the movant seeks to amend the judgment based on additional evidence, the movant must show that the evidence is newly discovered and—if the evidence was available, but undiscovered, at the time of the decision being challenged—that counsel made a diligent yet unsuccessful effort to discover the evidence. *Comm. for First Amendment v. Campbell*, 962 F.2d 1517, 1523 (10th Cir. 1992). A motion to amend should not be granted where the proposed additional findings of fact are not material to the court's conclusions. *Lyons*, 793 F. Supp. at 991.

"The granting of a motion to alter or amend is an extraordinary remedy which is used sparingly in order to further the strong public policy interest in finalizing litigation and conserving judicial resources." *Torre v. Federated Mut. Ins. Co.*, 906 F. Supp. 616, 619 (D. Kan. 1995). It is well established "that a district court does not abuse its discretion in denying a Rule 59 motion when it is premised on evidence that the [moving] party had in his control prior to the original entry of judgment." *Emmons v. McLaughlin*, 874 F.2d 351, 358 (6th Cir. 1989); *see also Coastal Transfer Co. v. Toyota Motor Sales*, U.S.A., 833 F.2d 208, 212 (9th Cir. 1987); *Taylor v. Texgas Corp.*, 831 F.2d 255, 259 (11th Cir. 1987). In light of my holding that the statements in Krieger's May 22, 2008, declaration were neither new nor newly discovered—and that the Government did not act diligently in any case—amendment under Rule 52(b) or Rule 59(e) is also inappropriate.

IV. CONCLUSION

Accordingly, the Government's Motion for a New Trial [**Docket # 258**] is DENIED.

Plaintiff is awarded costs.

Dated: July __18__, 2008.

BY THE COURT:

s/Lewis T. Babcock
Lewis T. Babcock, Judge