No. 08-1333

IN THE
UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

CARLOS E. SALA, TINA ZANOLINI-SALA

Plaintiffs/Appellees,

v.

UNITED STATES,

Defendant/Appellant.

ON APPEAL FROM THE JUDGMENT AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF COLORADO

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STATEMENT OF RELATED APPEALS

Pursuant to Circuit Rule 28.2(c)(1), Sala's counsel are unaware of any prior or related appeals.

STATEMENT OF THE ISSUES FOR REVIEW

Whether the district court erred in:

(1) concluding that the loss is allowable under the economic substance doctrine;

(2) finding that the taxpayer's loss met the requirements of § 165[1];

(3) determining that Treas. Reg. § 1.752-6(b)(2) does not disallow the loss; and

(4) denying the government's motion for a new trial.

STATEMENT OF THE CASE

This is a tax refund case. The district court ruled for Sala, and denied the government's motion for a new trial. This appeal followed.

STATEMENT OF THE FACTS

A. Events leading to Carlos Sala's ("Sala") investment with Deerhurst Management Company, Inc. ("Deerhurst").

After college, Sala spent six years with a national public accounting firm where he performed due diligence to verify the financial performance of business operations. (Aplee. Supp. App. 372-75). He then joined Dal-Tile International, Inc., the parent of a group of companies with annual sales of approximately $750 million. (*Id*. at 376). His duties included hedging transactions involving currency futures. (*Id*. at 376-78). In 1997,

[1] Unless otherwise specified, all citations to statutes are to statutes contained in Title 26 of the U.S. Code.

Sala became the CFO of Abacus Direct, Inc. ("Abacus"), a publicly-held company (*id*. at 378-79), where he was responsible for providing financial forecasts to analysts and investors. (*Id*. at 380). His compensation included stock options. (*Id*. at 379-80, 384).

In 1999, Abacus merged with DoubleClick, Inc. (*Id*. at 385). In February, 2000, Sala exercised his options and sold his stock. (*Id*. at 385-87). While he invested most of the proceeds in municipal bonds, a portion of the proceeds was placed in more aggressive investments, including options. (*Id*. at 387-89).

Sala had used PricewaterhouseCoopers ("PwC") to prepare his personal income tax returns. (*Id*. at 390). Jonathan Raby ("Raby") was the director in charge of Sala's personal account at PwC. (*Id*.). When Raby left PwC, Sala decided to look for another experienced CPA to prepare his future tax returns. (*Id*. at 391). One of Sala's personal friends, KPMG partner Tim Gillis, referred Sala to Tracie Henderson ("Henderson"), another KPMG partner, for tax return preparation services. (*Id*. at 391). Sala later engaged KPMG as his tax return preparer, with the understanding that Henderson would have overall responsibility for his tax returns. (*Id*. at 391-92).

Sala was introduced to several tax advantaged transactions, but he never gave them any significant consideration due to their inability to generate profits. (*Id*. at 396-404).

While Sala did not request Raby to "search for a tax shelter" for him, Raby did refer Sala to Michael Schwartz ("Schwartz"). (*Id*. at 404-05). Schwartz, a CPA with his own New York broker-dealer investment firm, did considerable investigation of a trading firm known as Deerhurst, observing its operations and analyzing its principal's

performance since the early 1990s. (*Id*. at 691-98).

Sala did not engage KPMG to make any evaluation of tax advantaged investments, either those promoted by KPMG, or those offered by third parties (including Deerhurst). (*Id*. at 395-96). Sala paid for Henderson's time to learn the details of the tax aspects of the Deerhurst Investment so she would feel comfortable with its treatment on Sala's 2000 tax return. (*Id*. at 392-96).

B. Andrew Krieger and Deerhurst.

In the 1980's, Andrew Krieger ("Krieger") worked for Solomon Brothers and Bankers Trust. (Aplt. App. 363; Aplee. Supp. App. 593-94). In 1987, he was responsible for a $228 million foreign exchange trading profit, for which he received, at age 31, a $3.25 million bonus. (Aplee. Supp. App. 633-35). Krieger subsequently worked for Soros Fund Management, where his foreign currency trading produced $45 million in trading profits. (Aplt. App. 363; Aplee. Supp. App. 636-37).

Krieger formed his own firm in 1991. (Aplee. Supp. App. 595A-C). From 1991 to 2004, Krieger managed investments in foreign currency and currency options. (*Id*. at 641-43). Krieger's annual rates of return from 1991 through 1999 were always positive, ranging from a low of 1.22% to a high of 42.84%, after fees. (*Id*. at 647-50, 235). A 1999 report by a CPA firm confirmed an average annual rate of return, net of expenses, of 20.70% from August 1995 to February 1999, and a total return for that period of 96.23%. (*Id*. at 240-46, 656-57, 693-96).

In early 1997, Krieger had $75 to $80 million under management. (*Id*. at 602).

Because he was offered the opportunity to trade exclusively for a single large investor, Ross Capital, Krieger returned the capital to his investors. (*Id*. at 600-02, 619). Thereafter, Krieger traded exclusively for Ross Capital. (*Id*. at 602-03, 619). Ross Capital ceased its trading activities in early 1999, because of trading losses unrelated to Krieger's investments. (*Id*. at 612-13).

Krieger then attempted to rebuild a long term capital base. (*Id*. at 658-60). Krieger's preference was to obtain investors who would commit to stay invested with Deerhurst for at least five years. (*Id*. at 660-61, 664).

In early 2000, Krieger met Schwartz, who told Krieger that he (Schwartz) advised high net worth clients, some of whom might be interested in the investment program. (*Id*. at 663-64).

An investment proposal was developed. It involved:

a. Placement of a minimum amount of funds with Deerhurst for a 30 to 45 day period. (*Id*. at 704, 477). Investors were free to withdraw their funds without penalty at any time during this initial period. (*Id*. at 704-05).

b. Investors desiring to continue were required to deposit substantial additional funds, which would remain invested during the latter part of 2000. (*Id*. at 477, 707-08; Aplt. App. 521-22).

c. If investors made a profit during the second phase of the

program, they were required to transfer their funds to a new entity, Deerhurst Trading Strategies, LLC ("Trading Strategies"), and remain invested with Trading Strategies for five years, or incur significant penalties for early withdrawal. (Aplee. Supp. App. 342A, 480, 707). If investors did not make a profit in 2000, continuation was at their discretion. (*Id*. at 707).

d. A significant tax benefit might be available in 2000, primarily through application of a rule of law requiring the disregard of short option positions as liabilities. (*Id*. at 342D).

e. No upfront fees would be charged to investors. (*Id*. at 342C-D). In accordance with industry practice, Deerhurst's fees were based upon a percentage of assets under management, and a percentage of profits. (*Id*. at 342C-D, 424, 710-11). Schwartz received a portion of Deerhurst's fees for referring investors and performing management services throughout the investment period. (*Id*. at 669A-C).

C. Sala's Deerhurst Investment.

Sala had multiple meetings with Krieger and Schwartz concerning Deerhurst. (*Id*. at 408-14). He visited Deerhurst's offices, observed trading operations, interviewed traders, and reviewed Deerhurst's administration and financial reporting policies. (*Id*. at

416-17). He read Krieger's book, "Money Bazaar," about foreign currencies and options. (*Id*. at 412-13). He contacted the Ross Perot investment office (a client of Krieger's) and obtained considerable information regarding Krieger's performance. (*Id*. at 414-15). He obtained similar information from other investors. (*Id*. at 414-16).

Sala reviewed reports of Krieger's performance from 1991 through 2000. (*Id*. at 240-246). Based upon these materials, Sala made his own projections regarding the expected profitability of a $9 million investment in Deerhurst over the next five years. (*Id*. at 430-31). He concluded the investment had a high profit potential. (*Id*. at 431-35). From his standpoint, the requirement that he commit $9 million (15% of his expected tax loss) to the program fit with his desire to place a portion of his investments in aggressive, non-equity related trading. (*Id*. at 435-37). Sala viewed the Deerhurst Investment as comparable to trading in options and other instruments he was then conducting. (*Id*. at 436-37).

Sala invested $500,000 during the initial period, and made a profit of approximately $9,395 in less than 30 days (an annualized return of over 25%). (*Id*. at 231-32, 717-19). After the initial period, Sala invested approximately $8.9 million. (*Id*. at 724).

During 2000, Deerhurst engaged in hundreds of trades on behalf of Sala and other investors. (*Id*. at 541-42, 630). The trades in the second phase of the Deerhurst Investment were conducted by Deerhurst Investors GP ("Deerhurst GP"). (Aplt. App. 369-70; Aplee. Supp. App. 705-06). Deerhurst GP had 11 partners, including Solid

Currencies, Inc. ("Solid"), Sala's S corporation in which he was the sole shareholder. (Aplee. Supp. App. 203, 220-21, 720). Deerhurst GP's total contributed capital was approximately $24 million. (*Id*. at 203). In addition to providing significant economic and administrative benefits by pooling investor funds in Deerhurst GP (*id*. at 672), the transfer by investors of their initial investments to a partnership, and the subsequent liquidation of that partnership before year end, resulted in an ordinary loss. (*Id.* at 342D).

Deerhurst GP bought and sold hundreds of option contracts controlling billions of dollars in currency, and it made a profit. (*Id.* at 203, 207). Its profits were divided among the partners, based upon their partnership interests. (*Id*. at 208-229). Sala's share of the Deerhurst GP profit was $77,435. (*Id.* at 720-21).

The 2000 trades for Sala included 24 foreign currency option positions which generated the tax basis that produced the tax loss. (*Id*. at 297). These 24 positions involved the sale of options for a total of $60,259,568.94, and the purchase of options for $60,987,866.79, for a net cost of $728,297.85.[2] (*Id*. at 230). The 24 options were terminated between December 1 and December 14, 2000, at a net profit of between $91,010 (Aplt. App. 516) and $111,599 (*id*. at 438). Each of the options had significant profit potential. (Aplee. Supp. App. 510). Collectively, the maximum profit potential of 22 of the options, excluding two British pound/Japanese yen ("GBP/JPY") long options,

[2] Jt. Ex. 24 shows 23 positions. (Aplee. Supp. App. 230). It shows the purchase on November 24, 2000, of a JPY long option with a face amount of 1,602,000 for a cost of $11,438. However, the purchase actually occurred on November 20, 2000, and consisted of two options which cost $12,210 together, one having a face amount of 183,600 (GBP) and the other a face amount of 1,418,400 (GBP). (*Id*. at 297, 522).

was between $545,130, (Aplee. Supp. App. 518-19; Aplt. App. 437), and $553,126 (Aplt. App. 512). The two GBP/JPY long options were not included in either expert's calculation of the maximum profit potential because, unlike the other 22 options, they were not part of a portfolio of related options where a profit or loss on one side of the portfolio would be partially offset by the opposite side. (Aplee. Supp. App. 523-25). Accordingly, the maximum profit was virtually limitless for the GBP/JPY long options (one expert calculated the maximum profit in excess of $2 million). (Aplt. App. 437; Aplee. Supp. App. 523-24). In an effort to be conservative, both experts left the GBP/JPY long options out of their maximum profit analysis. (Aplee. Supp. App. 437, 545-48). The two options did, however, have significant profit potential. (*Id*. at 523-25, 545-49). The $12,210 investment in these two options actually produced a profit of $49,767 (Aplt. App. 438). Thus, the profit potential of the 24 options was at least $595,000. (Aplee. Supp. App. 538-39, 548-49).

Krieger's trading for Sala's account during 2000 was consistent with his trading style over the preceding ten years. (*Id*. at 439-440). During this period, Sala reviewed statements and had discussions with Krieger, confirming that the trading was consistent with his previously disclosed trading habits. (*Id*.).

The 24 trades were also consistent with Krieger's historical trading strategy, and were not any less economically justified because they generated the tax loss. Two of the 24 trades consisted of a portfolio of two options and 20 were part of five, four option portfolios. (*Id*. at 526-27). These portfolios were "volatility" plays, designed to profit if a

exchange rates moved in either direction (but not profit if the rates remained constant), but to profit more if the rate moved in a particular direction. (*Id*. at 528-29). The two GBP/JPY options were "directional" plays, betting on the yen moving in one direction vis-à-vis the pound. (*Id*. at 512).

Krieger attempted to make significant profits for his investors during 2000 to show that he was a "worthy steward" who could be entrusted with their funds for the next five years. (*Id*. at 540, 663-64, 668).

Deerhurst Strategies incurred net losses in 2001 and 2003, and made a profit in 2002. (Aplee. Supp. App. 460-61, 725-26). Sala closely monitored his investment. (*Id*. at 460-61, 627). In 2004, because of the continuation of losses, Sala terminated his investment with Krieger. (*Id*. at 23, 466-67).

D. The District Court's determination.

The district court held that:

> [F]or 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.

(Aplt. App. 120).

The court based this holding upon its findings regarding the views and behavior of Sala, the other investors, and the promoters and managers of the program. (*Id*. at 114-16).

The court further found that: (1) *each phase* of the Deerhurst Investment had independent business purpose and economic substance, (*id*. at 123-24); (2) the 24 trades related to the tax loss had the potential to earn profits of at least $550,000 resulting in

a net annualized profit return of 45%, (*id*. at 126-27); and (3) the actual profit from the 24 trades was between $90,000 and $110,000, (*id*. at 128).

The district court further addressed the requirement of § 165(c)(2) that an allowable tax loss must arise from a transaction entered into for profit. The court held that, under § 7491, the government had the burden of proof on the issue of profit motive, and the government failed to meet its burden. (*Id*. at 137). The court ultimately concluded "Sala entered into the Deerhurst Investment with a good faith belief that the venture would create a benefit in excess of the anticipated tax loss" and the government failed to show "Sala did not enter into the Deerhurst Investment with a primary profit objective." (*Id*. at 137-41).

SUMMARY OF ARGUMENT

1. The keystone of the government's argument is that Sala's claimed $60 million loss is "noneconomic," "wholly artificial" and "manufactured out of whole cloth." (Aplt. Br. at 18-20). The fact a $728,000 investment in currency options produced a $60 million loss says nothing about the economics of the transactions that produced the loss. The loss is the result of applying a rule of law urged upon the tax court by the government over 30 years ago in *Helmer v. Comm'r*, 34 T.C.M. (CCH) 727 (1975), 1975 Tax Ct. Memo. LEXIS 212, to the taxpayer's detriment. Sala simply seeks to have the same rule of law apply in determining his partnership basis in this case.

2. The government argues that the district court's conclusions on the economic substance and profit motive issues rested entirely upon its consideration of the entire Deerhurst Investment, rather than the portion of the Investment which generated the tax loss. However, the district court made extensive findings supporting its conclusion that *each phase* had economic justification. The district court's consideration of both the entire program and each step within it is consistent with this Court's decision in *James v. Comm'r*, 899 F.2d 905, 910 (10th Cir. 1990) and is supported by judicial precedent.

3. The government did not adequately raise § 165(a) as a ground for disallowance. In any event, § 165(a) does not preclude Sala's claimed loss.

4. Treas. Reg. § 1.752-6 as applied to the transactions at issue in this case is beyond the authority granted by statute.

5. The government did not meet the any of the five requirements for obtaining a new trial.

ARGUMENT

I. The district court correctly concluded that both the entire Deerhurst Investment and the 24 option trades and related transactions that directly produced the tax loss had economic substance.

Standard of review

The district court's ultimate characterization of transactions as having economic substance is subject to *de novo* review. *Keeler v. Comm'r,* 243 F.3d 1212, 1217 (10th Cir.

2001). However, all of the findings of fact to which the district court applied the legal standards for determining economic substance are reviewed for clear error. *Id*.

When an issue on appeal is whether the trial court correctly applied a rule of law to the facts, such an issue is "sometimes called a ruling on a mixed question of fact and law" and appellate review is deferential under the clear error standard. *United States v. Frederick*, 182 F.3d 496, 499 (7th Cir. 1999); *see also Estate of Holl v. Comm'r*, 54 F.3d 648, 650 (10th Cir. 1995) (when mixed questions of law and fact are involved in the determination of an issue, a determination must be made whether it primarily involves a factual or legal inquiry; if it is the former, clearly erroneous review is appropriate). Because the issue on appeal is whether the district court properly applied a rule of law to the facts, and because the issue of economic substance is mainly a factual inquiry, a clearly erroneous standard of review is appropriate. [3]

A. Introduction.

In *James,* this Court held that whether there was a business purpose for transactions and whether the transactions had a reasonable possibility of profit are specific factors to consider in ultimately determining whether the transactions had "any practical economic effects other than the creation of tax losses." 899 F.2d at 908-09. This is precisely the standard applied by the district court in this case. (Aplt. App. 125-26).

The government seeks to divert attention from the district court's extensive

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[3] In *Boca Investerlings Partnership v. United States,* 314 F.3d 625 (D.C. Cir. 2002), the government argued that the district court's determination that transactions had economic substance were "mixed questions of law and fact and are reviewed for clear error." (Aplee. Supp. App. 732-33).

findings regarding business purposes, profit, and actual economic effects by labeling this case as merely another "Son of Boss tax shelter" which the government argues has no economic substance primarily because of the size of the tax loss in relation to the size of the investment in the transactions that gave rise to the loss. But the $60 million loss was not produced by transactions having no practical economic effect. Rather, the loss is a result of applying a rule of law requiring sold options to be disregarded in determining partnership basis.

The government's reliance on Notice 2000-44, 2002-2 C.B. 255 ("Notice 2000-44") is misplaced. In Notice 2000-44, the IRS described a hypothetical transaction where the taxpayer claimed his basis in his partnership interest was increased by the cost of purchased options, but not reduced by his partnership's assumption of the obligation with respect to sold options. Notice 2000-44 ignores *Helmer,* and does not acknowledge the rule of law requiring that the obligation represented by a sold option be disregarded. Moreover, the Notice states the transactions described by it had "nominal or zero" economic outlay and value. *Id*. Sala's $728,000 net cash outlay to acquire option positions that had a realistic possibility of profiting by over $550,000, and which actually made $90,000-$110,000 in approximately two weeks, can hardly be described as "nominal or zero."

The government states "three cases have held that the offsetting option shelter described in Notice 2000-44 lacks economic substance" citing *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11 (2007), *Stobie Creek Inv., LLC v. United States*, 82 Fed. Cl.

636 (2008), and *Maguire Partners-Master Inv., LLC v. United States*, 2009 U.S. Dist. LEXIS 8361 (C.D. Cal. Feb. 4, 2009). (Aplt. Br. at 26). A close examination of each of these cases will show they are factually distinguishable from Sala's.

Jade Trading held that *Helmer* and its progeny require sold options to be disregarded in determining partnership basis, such that the contribution of purchased options to a partnership along with the obligation of the sold options created a basis equal to the purchased options standing alone. *Jade Trading*, 80 Fed. Cl. at 45. However, in order to prevail, the taxpayers had to prove that the transactions generating the tax loss had economic substance, which, in turn, required "an objective determination of whether a reasonable possibility of profit from the transaction existed, exclusive of tax benefits." *Id*. at 45, 48. The court concluded "the fact that the [taxpayers] had to spend over $934,000 to obtain an investment return of $140,000 establishes that no reasonable investor would engage in such a transaction to earn a profit." *Id.* at 49-50. It also held that, while the "disproportionate tax advantage" in relation to the taxpayers' economic investment was a factor to consider, it was "not dispositive." *Id*. at 14. Only when considered together with the inability to make a profit, lack of investment character, and "meaningless" inclusion in a partnership did the court conclude the transaction lacked economic substance. *Id*.

Jade Trading provides no support for the government's position in this case because the district court found there was a realistic possibility of making a substantial profit on the transactions that generated the tax loss; there were no huge upfront fees; the transactions were consistent with the investment strategies employed by Krieger

irrespective of tax benefits; and the partnership was not meaningless.

In *Stobie Creek*, the court not only confirmed that *Helmer* was the law in 2000, when the relevant transactions took place, but it also held Treas. Reg. § 1.752-6 invalid as applied to the transaction at issue.[4] 82 Fed. Cl. at 671. However, as in *Jade Trading*, in order to prevail, the taxpayers had to prove that the transactions had economic substance. *Id*. at 672. In concluding the taxpayers failed to meet their burden, the court relied primarily on evidence that the transactions had no reasonable possibility of a profit. *Id*. at 692. The *Stobie Creek* court did not hold that *Sala* was wrongly decided; instead, it implicitly approved of the decision in *Sala* by carefully distinguishing the transactions before it from those in *Sala* based upon a number of factors, including: (1) the actual profitability of the basis generating trades; (2) the profit potential of the basis generating trades, as well as of the entire long-term investment program; and (3) the existence of a five year investment strategy and a profit-motivated business purpose supporting its continued long-term trading activities. *Id*. at 691-92.

The court in *Maguire Partners* made essentially the same analysis as did the courts in *Jade Trading* and *Stobie Creek*. It concluded there was no economic substance because the taxpayers "received no economic benefit, other than the increase in basis from the transactions … ." *Maguire Partners–Master Inv., LLC*, 2009 U.S. Dist. LEXIS at *28.

In summary, these cases do not establish that, as a matter of law, the transactions

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[4] Treas. Reg. § 1.752-6 is a retroactive regulation promulgated by Treasury in 2003, a portion of which is a "silver bullet," designed to reverse the rule of *Helmer* when that rule operates to the taxpayer's favor. The invalidity of this portion of the regulation is discussed in Section III below.

generating Sala's basis/loss had no economic substance simply because the basis was higher than Sala's economic investment in the transactions. Nor do they support the government's attempt to disregard the role that *Helmer* and its progeny play in permitting the basis increase to occur. An examination of the *Helmer* rule reveals there is good reason for the government to ignore its application. It was a rule the government urged upon the courts to the taxpayer's detriment. However, when the same rule now operates in the taxpayer's favor, the government seeks to ignore it. The government's attempt to leave the rule in place when it increases taxes, but ignore it where it minimizes taxes, is indefensible.

B. Helmer was the law at the time Sala engaged in the transactions generating the tax loss. It must be uniformly applied regardless of whether it benefits the taxpayer or the government.

In *Helmer*, a partnership sold an option to purchase property. 2000 Tax Ct. LEXIS at *3-4. The purchaser made the option payments directly to the partners. *Id*. at *4-6. The IRS asserted that the payments were distributions by the partnership and were taxable because they exceeded the partners' basis in their partnership interest under § 731(a). *Id*. at *8. The partners argued that the option was a liability of the partnership which, under § 752(a), increased the partners' basis in the partnership interest and fully offset the distribution. *Id*. at *12-13. The court held that the obligation to apply the option proceeds against the property's purchase price was not a "liability" within the meaning of § 752, because it was contingent. *Id*. at *14-15. Thus, the partners were liable for tax on the gain deemed to have occurred, even though unless and until the option expired unexercised, the

partnership still retained the obligation to perform. *Id*.

The *Helmer* court further acknowledged that, under the authority of *Virginia Iron and Coke Co. v. Comm'r*, 37 BTA 195 (1938), *aff'd* 99 F.2d 919, 921, *cert. denied* 307 U.S. 630 (1939), no income was to be recognized by the partnership until the option was either exercised or expired, and the tax consequences of the transaction could be determined. *Id*. at *15. But this did not relieve the partner of having to recognize gain upon receipt of the proceeds, even though, when the dust ultimately cleared, there might be no economic gain at all.

The Tax Court confirmed that *Helmer* was still the law in 2000 in *Salina Partnership LP v. Comm'r*, 80 T.C.M. (CCH) 686, 2000 Tax Ct. Memo. LEXIS 421 at *60.[5] *Jade Trading* quoted a 1995 IRS Memorandum stating:

> Existing authority is contrary to a position that options create liabilities. *Helmer* held that no partnership liability is created upon receipt of option payments by a partnership.

80 Fed. Cl. 11, 44 (2007).

When Treasury attempted in 2003 to retroactively require that sold options be treated as liabilities for purposes of § 752, it acknowledged its proposed regulation would effect a change of law: "[t]he definition of a liability contained in these proposed regulations does not follow *Helmer*." 68 Fed. Reg. 37434, 37436.

In explaining how "mechanically" Sala's $60 million loss arose, the government states: "Solid and Deerhurst GP did not, however, treat Deerhurst GP's assumption of

[5] *See also LaRue v. Comm'r*, 90 T.C. 465, 479-480 (1988); *Long v. Comm'r*, 660 F.2d 416, 419 (10th Cir. 1981), *aff'g* 71 T.C. 1 (1978).

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." (Aplt. Br. at 30). This is not some position that Sala "manufactured out of whole cloth." (Aplt. Br. at 20). It is a position which the government is responsible for and the courts have applied. It involves an interpretation of the term "liability" in § 752. The government argues for opposite interpretations of the same word, depending upon who benefits—the government or the taxpayer. The court in *Klamath Strategic Inv. Fund, LLC, v. United States*, 440 F. Supp. 2d 608, 619 (E.D. Tex. 2006), rejected that argument and stated "This court's analysis of 'liability' under § 752 will not vary in meaning simply based on whose ox is being gored."

The government's broad attempt to support its case by describing Sala's loss as "fictitious," resulting from a "highly inflated basis," and employing a strategy "widely marketed to wealthy individuals," (Aplt. Br. at 24-27), is nothing more than an effort to deflect an objective analysis of the facts and law that should control the outcome of this case.

Perceived "policy concerns" on the part of the government were rejected by the Supreme Court as a basis for denying tax benefits in *Gitlitz v. Comm'r*, 531 U.S. 206, 219-220 (2001). There, taxpayers' claimed losses resulted from increasing their stock basis by their S corporation's non-taxable debt relief income. The Supreme Court noted that the basis increase was not supported by any "economic outlay" of the taxpayers. *Id*. at 212.

While the government argued the taxpayers sought a "double windfall," the Supreme Court held that was beside the point, because the tax law supported the taxpayers' position. *Id*. at 219-20. It rejected the government's result-driven view as to what the law "should be." *Id*. The district court did the same in this case.

C. The district court correctly considered both the entire Deerhurst Investment and the specific transactions that directly generated the tax loss in determining whether the economic substance requirement is satisfied.

1. Introduction.

The government's argument that the district court erroneously applied the "economic substance" doctrine fails because it: (1) is based upon erroneous assumptions as to what the district court did and did not consider; (2) misstates key facts regarding profit and profit potential; and (3) does not show the district court's findings regarding business purpose were clearly erroneous.

It should be recognized what is not in dispute: in examining whether the transactions had a reasonable possibility of profit, a business purpose, and, ultimately, whether they had practical economic effects, the district court applied the correct standards. (Aplt. App. 124-26 and authorities cited therein).

However, because the post-2000 portion of the Deerhurst Investment had no tax benefits, the government embarks upon a lengthy argument that the district court should not have considered the entire Deerhurst Investment in determining economic substance. It asserts "it was reversible error for the district court to fail to analyze the economic

substance of the Deerhurst GP transaction in and of itself." (Aplt. Br. at 38).[6]

To the contrary, the district court *did* analyze the economic substance of the Deerhurst GP transaction in isolation. The court stated "I view the transaction as a whole and *each step*—from commencement to consummation—is relevant." (Aplt. App. 126) (emphasis supplied). Focusing only upon the steps the government believes are relevant, the district court found:

> 1) the 24 basis generating trades had a profit potential of $550,000, excluding the "pound-Japanese yen play," which in fact earned over 500% of its cost in one month (Aplt. App. 126-127);
>
> 2) Sala's $728,000 investment in the basis trades earned actual net profits of between $90,000-$110,000, a monthly return well over 10% (*id*. at 128);
>
> 3) Sala testified credibly at trial that *each phase* of the Program was structured to provide non-tax business benefits, as well as significant tax benefits (*id*. at 129);
>
> 4) Solid had a legitimate business purpose (*id*. at 130);
>
> 5) Deerhurst GP had legitimate business purposes and real economic effects: (a) its partners "entered into the Deerhurst GP with a good faith intent to join together for the purpose of investing in currency options and sharing profits, losses and expenses" (*id*. at 131-33); (b) it engaged in substantial business activity, conducting transactions involving hundreds of option contracts controlling billions of dollars of currency, and achieved substantial profits; (c) the contribution by Sala and other partners of option contracts to Deerhurst GP permitted cost savings, increased efficiency, spread the risk of exposure, and allowed higher leverage and profit potential (*id*.);

[6] The government apparently uses the term "Deerhurst GP transaction" to refer to the acquisition and disposition of the basis generating trades and the transactions involving Deerhurst GP.

> 6) liquidating Deerhurst GP at the end of the year had legitimate business purposes other than the creation of tax losses, including protection against year-end volatility in the market, and producing actual profits which could only be realized by selling the underlying contracts (*id*.);
>
> 7) "viewing the Deerhurst GP transactions in their individual steps and in their entirety," each transaction involving the partnership had a "substantial business purpose other than the creation of tax losses" (*id*. at 133);
>
> 8) The fact Sala was committed to the long-term Deerhurst Investment if the Deerhurst GP "made even a penny of profit" does not, as the government argued, show that Sala was only interested in a tax loss. The test period helped ensure that investors, including Sala, would become comfortable with the program and would remain invested for the long term. (*id*. at 133-34);
>
> 9) the trading during 2000, was consistent with Krieger's historical trading style in terms of the account amount invested at any particular time, the risk/reward potential of the trades, and the actual return (*id*. at 134); and
>
> 10) the use of 4-option sets for the basis generating trades had a legitimate business purpose aside from generating the tax loss. There was no evidence that the strategy "lacked a business purpose or was in any way unusual or suspect." (*Id*. at 135).

The district court's factual findings relate to the specific transactions that directly generated the tax loss and support its conclusion that the transactions had economic substance—i.e., a reasonable possibility of profit, business purposes, and "practical economic effects." The government attempts to create an issue that does not exist.

The district court made very few findings that relate only to the non-Deerhurst GP transactions. It analyzed the profit potential of Sala's $9 million investment over a five

year period, but it did so based upon its finding of the profit potential and actual profits of the basis trades. (Aplt. App. 127-28). The district court's finding that the program "considered as a whole" had a business purpose (Aplt. App. 136) does nothing to impair its findings that *each phase* of the 2000 portion of the program likewise had economic substance.

In any event, the law does not require the court to put blinders on and ignore the entire program of which Deerhurst GP was an integral part. The district court found that the investment in this case, unlike *Jade Trading, Stobie Creek* and *Maguire Partners,* was not a "quick in and out" where the tax benefits were realized and nothing further happens, nor was anything further intended to happen. That speaks volumes about real business purpose and economics.

2. There is no rule of law which precluded the district court from considering the entire Deerhurst Investment.

The government erroneously alleges that before Sala selected Deerhurst, he embarked on a "search" for a tax shelter, considered the "OPIS" shelter and tentatively agreed to participate in "BLIPS." (Aplt. Br. at 4-5). If untaken paths have any relevance, certainly the entirety of the program in which he *did* participate has relevance.

The government states the Deerhurst GP transaction was "a self-contained transaction that was discrete from the Deerhurst LLC trading program." (Aplt. Br. at 46). Whether that is true is a factual issue. The district court found that the Deerhurst GP transaction had business purposes in the context of the entire investment, from the

standpoint of the investors, including Sala, and of Krieger. The government fails to show that the findings are clearly erroneous.

The government cites two cases for the proposition that courts are required to examine only that narrow portion of the investment which relates to tax benefits, *James*, 899 F.2d at 910 and *Klamath Strategic Invest. Fund, LLC, v. United States*, 472 F. Supp. 2d 885 (E.D. Tex. 2007). In *James*, the taxpayers' joint ventures entered into purported purchase agreements with corporations. 899 F.2d at 906. The corporations purchased computer equipment from manufacturers and leased the equipment. *Id*. at 906-07. The taxpayers argued the corporations were "undisclosed agents" of the joint venture, entitling them to tax benefits as the owners and lessors of the equipment. *Id*. at 909.

In rejecting the taxpayers' argument, this district court considered *all elements* of the transactions between the corporations, their sellers and lessees, as well as the details of the transactions of the joint ventures. *Id*. The court looked both to the transactions directly generating the tax benefits (those between the joint ventures and the corporations), and the transactions between the corporations and the third parties. It did not narrowly focus its inquiry as the government argues the district court should have done in this case.

James rejected the taxpayers' argument that the "deal" must "stand or fall in toto," such that, if the corporations' transactions with the third parties had economic substance, so too did the corporations' transactions with the joint ventures. *Id*. at 910. It held that the economic substance of the transactions "on the periphery" of the joint venture

transactions did not establish the economic substance of the joint venture.

The district court did not hold that the non-Deerhurst GP portion of the Deerhurst Investment established the substance of the Deerhurst GP portion of the program. It found that the post-2000 part of the program was not "on the periphery" of the earlier portions of the program; instead, it held that Deerhurst GP was a legitimate test period leading to a subsequent long term investment. (Aplt. App. 115, 122, 133-34). It also found that the earlier period had independent economic substance. That was not the case in *James.*

In *Klamath*, the taxpayers argued that loan transactions which directly generated tax benefits had economic substance because they were part of a seven year program involving foreign currency investments. 472 F. Supp. 2d at 890, 895. The court stated "[w]hen 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 … ." *Id*. at 895. It is this statement the government relies upon in its brief. (Aplt. Br. at 42).

Immediately following the quoted statement, the *Klamath* court made the following analysis pertaining to its "application" of economic substance principals: (1) the parties did not intend the loan transactions to fund the foreign currency trades over seven years; (2) the parties intended at the outset that the taxpayer investors would exit the program in 60 days; (3) the economic substance of the transactions must be judged by what "the entire record" suggests, concluding that "viewed in the context of the entire record in this case, the loan transactions lacked economic substance"; and (4) there was no tax

independent business purpose for the loan transactions. *Id*. at 896-98.

Just as the court in *Klamath* looked to the relationship between the basis-generating loan transactions and the remainder of the investment program, the district court in this case carefully examined whether the basis generating transactions had a business purpose and profit potential in the context of the entire investment program. It distinguished *Klamath* on the grounds that neither Sala nor the other players in the program intended to exit after the tax benefits were generated. They looked at the program from the inception as long term. It found that there were tax independent purposes for the basis-generating transaction.

The government argues the district court erroneously relied upon the tax court's opinion in *Salina*.[7] (Aplt. Br. at 43-46). It states "*Salina*, a memorandum decision" has "no precedential effect" in the tax court, citing *Huffman v. Comm'r* 126 T.C. 322, 350 (2006). (Aplt. Br. at 45). *Huffman*, however, merely noted that memorandum decisions are not *binding*. 126 T.C. at 350.

The government's argument is squarely contrary to its argument in *Kornman & Assocs., Inc. v. United States*, 527 F.3d 443 (5th Cir. 2008)[8]:

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[7] In *Salina*, the taxpayer won on the economic substance issue. 2000 Tax Ct. Memo LEXIS at *40. The court held that the short sale obligation at issue in that case was a liability within the meaning of § 752 because the obligation to replace the borrowed securities was not contingent. *Id*. at *64. It distinguished options such as those involved in this case on the grounds that the option is contingent because it may not be exercised. *Id*. at *57-60.

[8] The taxpayer's obligation in *Kornman* arose out of a short sale, not an option. The government therefore argued in *Kornman* that *Salina* was persuasive precedent in support of its position. The court of appeals agreed that a short sale constitutes a liability for purposes of § 752.

> Appellants attempt to minimize *Salina* by urging … that Tax Court memorandum opinions have no precedential value. *That memorandum opinions are not precedent in the Tax Court merely means that one Tax Court judge is not bound by another judge's memorandum opinions*, just as one circuit court of appeals is not bound by the decision of another circuit court of appeals. *But that hardly means that memorandum opinions do not have persuasive value. Indeed, this Court has frequently relied on them*. (citations omitted)

(Aplee. Supp. App. 736)(emphasis supplied).

Salina rejected the IRS's argument that the economic substance analysis should focus *solely* upon the portion of a claimed multi-year investment program that produces tax benefits. 2000 Tax Ct. Memo. LEXIS at *36. It did so because it found as a fact the entire program and its individual phases were evaluated by the taxpayer for economic benefits as well as tax benefits; the funds from the first phase of the program were required to be liquidated and placed in the second phase; and that the taxpayers' funds were invested in the second phase for several years. *Id*. at *36-39. *Salina* made the same type of factual analysis as the *Klamath* court, but instead of finding there was never a real intent to proceed beyond the short period during which the tax benefits were generated, it found there was a long-term investment motive. *Id*. at *30. The district court considered *Salina* precedent because it reached the same factual findings regarding the existence of a long-term investment program as the district court reached in this case.

D. The basis generating trades had economic substance.

The government argues that the basis generating trades had no reasonable possibility of generating profit, contrary to the district court's findings. Before addressing

that argument, however, it should be recognized that under *James*, the possibility of profit is one factor relevant to the ultimate question of whether the transaction had "practical economic effects." 899 F.2d at 908-909. Many of the district court's findings bear upon that ultimate question, including: (1) the structure of the trades—offsetting portfolios of foreign currencies betting both on volatility and long term market direction—was consistent with Krieger's historical trading strategy (Aplee. Supp. App. 134); (2) the trades were part of the test period which had business purposes (*id.*); and (3) the expenses and profits relating to the trades were actually shared among Sala and his partners in accordance with their economic interests. (*Id.* at 131). Those are all practical economic effects other than tax losses.

The district court found that the trades had a profit potential of *at least* $550,000:

> [E]xcluding a directional British pound—Japanese yen play [and] . . . . [a]ccounting for the directional play, the profit potential was much higher.

(Aplt. App. 126).

The excluded trades actually made a profit of approximately $50,000. For the first time, the government attempts to ignore these profitable trades in a determined effort to whittle down the numbers. (Aplt. Br. at 9 n.9).[9] However, as both experts testified, the

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[9] Notably, this Court will not see the government's numbers (which disregard the pound-yen options) of $60,976,429 and $716,860 anywhere in the record below. It was undisputed in the district court that $60,987,867 amounted to the premiums paid for the basis trades and the net out of pocket was $728,298. The government's Proposed Findings of Facts and Conclusions of Law and own expert concluded the pound-yen options were part of the basis trades. (Aplt. App. 70, 85, 516). The government expert, Dr. DeRosa ("DeRosa"), included the pound-yen in his ultimate conclusion that the basis

maximum profit potential was *at least* approximately $595,000 (including the pound—yen options).[10]

The government argues the district court "mistakenly stated" that DeRosa concluded the possibility of the trades achieving their maximum profit potential was as high as 50%, because DeRosa actually concluded the possibility of any one-sided spread was as high as 50%. (Aplt. Br. at 47). The district court, in fact, correctly analyzed DeRosa's opinions on this matter. DeRosa stated, "the odds of getting the maximum return would be less than the weighted average of the five, perhaps significantly ... ." (Aplt. App. 514). The district court found the possibility of achieving the maximum profit was "small," but "based on DeRosa's estimates that the trades had, at most, a 50% likelihood of reaching maximum profit of profitability in any one year—the potential was still significant." (*Id*. at 127-28).

The government argues the profit potential determined by both experts and the Court should be further reduced by approximately $500,000 to account for mark-up fees which it argues *could have been* charged by Beckenham Trading Company ("BTC"). BTC was a company formed by Krieger for the purpose of executing trades. Based upon the uncontradicted testimony the district court found that, during 2000, BTC charged

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trades made an actual profit of $91,010. (Aplt. App. 516). The government misleads this Court in stating that the pound-yen trades were not part of the set of trades that were related to the tax loss. (Aplt. Br. 9 n.9). The basis claimed was equal to the amount of premiums paid for the long option positions. Sala paid approximately $12,000 for the pound-yen trades and this amount was included in the $60,987,867 million tax basis claimed on the return. (Aplee. Supp. App. 230, 311).

[10] See Section C of the Statement of Facts above. (Aplee. Supp. App. 538-39, 548-49.)

nothing for executing the trades. (Aplt. App. 118; Aplee. Supp. App. 495, 680-84). Citing no evidence, the government states "sometime" BTC "apparently decided to waive the $500,000 that it was due." (Aplt. Br. at 49 n.19). That is not true. The testimony is uncontradicted that Krieger did not propose to charge BTC fees unless and until it was in a position to acquire option positions at a cost substantially less than that being paid to acquire them through Refco. (Aplee. Supp. App at 670-71). The district court found, "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." [11] (Aplt. App. 139).

The district court used the profit potential of the 24 positions to project the profit potential over five years. In doing so, it estimated the BTC fees that would be charged. Its estimate is irrelevant to the profit potential of the 24 positions since no fee was charged or intended to be charged. Moreover, the government is wrong in stating that the court should have determined projected fees of $500,000, not $9,000.

The government omits the critical language in its quote of the Customer Agreement and Trading Authorization with Deerhurst where the agreement states a fee range of $17 to $325 per million, not a flat $150 as the government suggests:

[11] BTC was created to eliminate the inefficiencies in using just one broker who could monopolize the pricing of options. Refco was an expensive counterparty whose clearing fees were embedded between the bid-ask spread. BTC was created to reduce the fees by using a pool of brokers who would offer more competitive pricing. Kolb concluded that the BTC fees were of no consequence because they would be less than the fees Refco charged. If BTC were to have charged fees before it was providing services, such fees would have been duplicative of the Refco fees and not representative of the actual profits Deerhurst could produce. (Aplee. Supp. App. 542A-B).

> BTC will receive mark-ups with respect thereto equal to one and one-half (1½) "PIPs" per roundturn (that is, at current exchange rates, approximately **$17 - $325 per $1 million** on a roundturn transaction basis (an average of approximately $150 per $1 million per roundturn)).

(Aplt. App. 524) (emphasis supplied). Krieger testified that, even after 2000, when BTC started charging fees, the amount charged was closer to $15 or $20 per million as opposed to $150 per million. (Aplee. Supp. App. 671A-671B). Moreover, the fee was only charged on one side of the four sided spread. (*Id*. at 685-685A). DeRosa, whose supposed "uncontradicted testimony" the government relies upon in support of its $500,000 figure, includes each side of the four sided spreads. Krieger testified the fees would only be charged on one side of the four sided pairs, which multiplied by $15 would result in $11,700 in fees, not the exaggerated sum of $500,000 asserted by the government.

The government argues that the cost of the tax opinion letter ($75,000), should be taken into account as a transaction cost, thus further reducing profit potential, citing *Long-Term Capital Holdings v. United States,* 330 F. Supp. 2d 122, 175-177 (D. Conn. 2004), *aff'd* 150 Fed. App'x. 40 (2d Cir. 2005) (unpublished)*; Stobie Creek Inv., LLC*, 82 Fed. Cl. at 694 and *Jade Trading*, 80 Fed. Cl. at 14. These cases do not hold that tax opinion fees are to be treated as transaction costs in determining profit potential for economic substance purposes. They considered the amount of the upfront fees (over $1 million in *Long-Term Capital Holdings,* 330 F. Supp. 2d at 175-76, and $4 million in *Stobie Creek,* 82 Fed. Cl. At 694) in determining whether a reasonable investor would have entered into

the transaction with an expectation of profit excluding tax benefits. In Sala's case, the fees were minimal in relation to his projected profit over five years, and to the profit potential of the basis generating trades themselves. They were not, as in the case of *Stobie Creek*, based upon a percentage of the tax savings. 82 Fed. Cl. at 651. They were charged and paid in 2001 after the basis generating trades occurred, and are deductible not as a transaction cost, but as an expense incurred in connection with the determination of tax under § 212(3).

The government argues that a "substantial portion" of the fees paid to KPMG and legal fees should be considered as transaction costs as well. (Aplt. Br. at 50). The fees paid to KPMG were for preparation of Sala's entire 2000 tax return, deductible under § 212(3). The legal fees paid to Nemirow related to his review of the tax opinion, as well as considerable non-tax advice and services to Sala in reviewing, revising and preparing legal documents regarding the entire Deerhurst Investment in his role as a business and transaction lawyer. (Aplee. Supp. App. 443-45). Once again, the government exaggerates the significance of expenses in its misguided attempt to persuade this Court that the district court's findings of fact are clearly erroneous.

In *Keeler*, this Court concluded that, simply because the taxpayers could point to ways they could "theoretically profit" and to some "individually profitable trades," the trial court was not foreclosed from finding that there was no economic substance. The *Keeler* taxpayers were found to have been "motivated exclusively by the tax losses." In contrast, the district court in this case found the transactions had significant profit

potential, substantial actual profit, and business purpose, and that Sala was motivated more by economics than by potential tax benefits. (Aplt. App. 163-64). *Keeler* provides no support for setting aside the district court's findings that led it to conclude there was economic substance.

The government states the economic profit potential of the Deerhurst GP transactions "was miniscule in comparison to the promised tax savings of $23 million." (Aplt. Br. at 52). As the district court found, Sala did not view the tax savings as "promised." He viewed them as "speculative." (Aplt. App. 137).[12]

The government argues "the Deerhurst GP transaction had no tax independent business purpose," and states "that the entire concept of the 'test period' was a ruse is self-evident." (Aplt. Br. at 53-54). This is "self-evident" to the government because it chooses to ignore entirely the district court's finding that the test period had legitimate business purposes (Section I.C *supra*.). The government further argues that "the lynchpin of proof" that the Deerhurst GP transaction had no business purpose is the contemplation that the trades and the partnership would be unwound by the end of the year. Again, the government only views this as conclusive because it ignores the district court's detailed

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[12] The government notes that Sala negotiated an arrangement with Deerhurst whereby he could withdraw from the program if he did not receive a favorable tax opinion, or received a deficiency notice from the IRS. (Aplt. Br. at 8). The government fails to cite Sala's testimony that he did this to ensure he would have the liquidity if he needed to pay taxes with the filing of his return (in the event of an unsatisfactory tax opinion) or the IRS's subsequent assertion that he owed the taxes. (Aplee. Supp. App. 446-49). He simply wanted this option. Sala in fact paid the full amount of the taxes with the filing of his amended return in 2003, but did not withdraw the amounts necessary to do so from Deerhurst. (*Id*. at 466-67).

findings as to the business purposes for liquidating the positions and the Deerhurst GP prior to the end of the year.

The government acknowledges that Krieger, in his trial testimony, "indicated that there were business reasons for closing out the offsetting currency positions at the close of the year 2000," but sweeps it aside with a citation to Krieger's post-trial declaration, which is not evidence in this case. (Aplt. Br. at 54). This is nothing short of outrageous. It says much about the government's refusal to confront the evidence in this case which amply supports the district court's findings.

II. The loss is allowable under §§ 165(a) and (c)(2). However, this Court should not consider the government's argument relating to § 165(a) because it was not adequately raised before the district court.

Standard of review

Citing no authority, the government claims that the issues under § 165 are questions of law subject to *de novo* review. (Aplt. Br. at 55-56). However, the Tenth Circuit has ruled that whether a loss has been "sustained" under § 165(a) presents mixed questions of law and fact. *Jeppsen v. Comm'r*, 128 F.3d 1410, 1415, 1417 (10th Cir. 1997). In addition, whether a loss results from a transaction entered into for profit under § 165(c)(2) is a question of fact reviewable under the clearly erroneous standard. *Keeler,* 243 F.3d at 1219.

Although appellate courts have discretion, they generally "will not consider an issue raised for the first time on appeal." *Tele-Communications, Inc. v. Comm'r,* 104 F.3d 1229, 1232-33 (10th Cir. 1997).

A. Because the government did not adequately raise § 165(a) before the district court, the issue should not be considered.

The government argues that the loss is not allowable because it was not "sustained" within the meaning of § 165(a), and was not "bona fide" as required by the Treasury Regulations thereunder. The government argues it "indirectly raised" the § 165(a) issue in its proposed findings,[13] and directly raised it in opening statement. (Aplt. Br. at 56).

In its proposed findings, the government did not even cite § 165(a), nor the Treasury Regulations relating to it. (Aplee. Supp. App. 69-181). Instead, it stated a loss must "reflect actual economic consequences sustained in economically substantive transactions" in support of its argument pertaining to the economic substance judicial doctrine. (*Id*. at 90, ¶ 33). Government counsel briefly alluded to § 165(a) in his opening statement (*id*. at 364-65), but made no reference to it in his closing argument. (*Id*. at 551-90).

In *Tele-Communications,* the Commissioner sought to raise on appeal an "alternative argument" made in one paragraph of the brief submitted to the tax court, which was summarily rejected. This Court refused to consider the argument on appeal, stating:

> Propounding new arguments on appeal in an attempt to prompt us to reverse the trial court undermines important judicial values. In order to preserve the integrity of the appellate structure, we should not be considered a "second-shot" forum, a forum where secondary, back-up theories may be mounted for the first time. *Id.* Parties must be encouraged

[13] The parties' proposed Findings of Fact and Conclusions of Law contained the bulk of the parties' briefings of legal issues before the district court. (Aplee. Supp. App. 69-181).

> to "give it everything they've got" at the trial level. *Id.* Thus, an issue must be "'presented to, considered [and] decided by the trial court'" before it can be raised on appeal.

104 F.3d at 1233 (internal citations omitted).

The same rule should apply here, where the government did not bother to brief the issue for the district court. The government is quick to point out that the district court did not rule on the § 165(a) issue, and it criticizes the district court for not doing so. (Aplt. Br. at 56, 63). However, the court did not consider the government's § 165(a) argument because the government did not present the issue.

In essence, the government argues that § 165(a) requires that a claimed loss be matched by an economic outlay in order for a loss to have been "sustained." It argues the regulations and case law support that interpretation. The district court was never given the opportunity to consider this argument, despite the fact it went to great lengths to consider and address all arguments made by the parties.

B. The loss is allowable under § 165(a).

The statute requires a loss be "sustained," and Treas. Reg. § 1.165-1(b) states it must be "bona fide" and supported by "substance and not mere form." Sala's loss resulted from real transactions with real economic effects that had true substance, as found by the district court. The loss was "sustained" because the assets' basis, generated by the long positions and unreduced by the short positions, exceeded the amount realized upon disposition. The difference between the amount of the tax loss and the cash investment in the transactions generating it results from applying the *Helmer* rule of law, which makes

the loss "bona fide." Nothing in §165(a), or the regulation suggests the loss is not allowable because it is not matched by an economic outlay.

In "*Selling the 'Noneconomic Loss Doctrine*,'" the authors conclude, citing numerous authorities:

> [E]very case addressing Treas. Reg. § 1.165-1(b) has interpreted the bona fide requirement by referring, not to the economic nature of the loss but to the manner of disposition of the asset that gave rise to the loss. The bona fide loss language of the section refers not to the loss itself, but to the *transaction* that led to the asserted recognition of the loss.

BRUCE LEMONS, JAMES WHITMIRE, & RANDY BICKHAM, *Selling the 'Noneconomic Loss Doctrine*,' TAX ANALYSTS, July 16, 2002 (emphasis supplied.)

If the government's economic outlay argument were correct, then many losses resulting from statutory depreciation of an asset used in a business would not be allowable. Depreciation under §§ 167 and 168 is allowed without regard to actual economic decline, if any, in the value of an asset used in a business. Indeed, even if the asset were actually appreciating in value, which is often the case with commercial buildings, a loss due to depreciation is nevertheless "bona fide." The tax benefit is determined by statute and regulations, not economics.[14]

In *Gitlitz*, there was no question that the taxpayer's claimed loss was not backed up

[14] Similarly, a taxpayer who inherits property is permitted to take a basis in property equal to the value of the property on the decedent's date of death. § 1014. If an inherited asset was purchased for little or no money by the decedent, had a high value at the date of death, and declined in value after the date of death, the inheriting taxpayer is still entitled to claim a loss on the sale of the asset, despite the fact that there was no "economic outlay" by either the decedent or the taxpayer, merely the operation of a rule of law.

by any outlay on the part of the taxpayer—the money to fund the losses came from funds borrowed by the corporation from a commercial lender. 531 U.S. at 218-20. The shareholders were in no way poorer as a result of the nontaxable debt relief income to the corporation which permitted the shareholders to increase their basis and generate a loss. But the Supreme Court held that was irrelevant because the law permitted the increase in basis and deduction of the resulting loss.

The government argues *Gitlitz* does not apply because the § 165(a) requirement that a loss be "sustained" and "bona fide" was not at issue. (Aplt. Br. at 56-57). But the Supreme Court expressly rejected the government's same "economic outlay" and "windfall" arguments it makes in this case. *Giltlitz*, 531 U.S. at 213-14, 219-20. Thus, the Supreme Court clearly concluded, without using the precise words, the losses at issue were "sustained" and "bona fide." Further, the losses involved in *Gitlitz*, in order to be deductible, had to qualify under § 165(a), as they do in this case.[15]

Section 165(a) was expressly addressed in *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991). There, the taxpayer exchanged high basis, low value interests in mortgages for similar interests of approximately the same value, and claimed a loss resulting from the exchange. The purpose of the exchange was to generate tax losses even though the transactions "would not substantially affect the economic position of the [taxpayer]." (*Id.* at 557). The Sixth Circuit in *Cottage Savings* held that no loss was

[15] The losses were generated from operations of the S corporation. S corporation income and deductions are generally determined in the same manner as individuals. § 1363(b). The loss of the S corporation passes through to the shareholders. § 1366(a). Both S corporations and individuals are allowed deductions for these losses by virtue of § 165(a).

sustained under § 165(a) because the taxpayer's "economic position was not changed for the worse" citing the statement in *Shoenberg v. Comm'r*, 77 F.2d 446, 449 (8th Cir. 1935), that no loss is sustained under the statute unless the taxpayer is "poorer to the extent of the loss claimed." *Cottage Savings Ass'n v. Comm'r*, 890 F.2d 848, 854-55 (6th Cir. 1989), *rev'd*, 499 U.S. 554 (1991). The Supreme Court reversed, holding that the losses were sustained under § 165(a) and were bona fide within the meaning of the regulations because the *transactions* that generated them were conducted at arms length. *Cottage Savings*, 499 U.S. at 568. So too were the transactions in this case.

The government quotes the same "poorer to the extent of the loss" language from the *Shoenberg* opinion as did the Sixth Circuit in *Cottage Savings*, and claims that *Shoenberg* is a "classic judicial expression of this aspect of § 165(a) that dates from 1935." (Aplt. Br. at 60). Attempting to cloak its argument with the weight of history, the government fails to acknowledge the 1991 *Cottage Savings* Supreme Court decision that squarely rejects its § 165(a) economic loss argument.

ACM Partnership v. Comm'r, 157 F.3d 231, 252 (3d Cir. 1998) held that "losses such as these, which are purely an artifact of tax accounting methods and which do not correspond to any actual economic loss, do not constitute the type of 'bona fide' losses that are deductible under the [Code] and regulations." The court stated the losses at issue were "not the bona fide result of an economic substantive transaction." *Id.* Sala's loss was not an "artifact of tax accounting methods." Rather, it resulted from application of a

rule of law to real transactions with economic substance. [16]

The government's reliance on *Keeler* is likewise misplaced. *Keeler* did not even address the §165(a) economic outlay argument the government makes here. [17] It only addressed the judicial economic substance doctrine and the profit motive requirement of § 165(c)(2). *Keeler*, 243 F.3d at 1217-20. Moreover, the court held that transactions having no realistic profit potential and producing losses fully eliminated by offsetting gains in straddle positions had no economic substance. *Id*. The court refused to focus only upon the loss leg of the straddle and ignore the gain side because to do so "distorted taxpayer's economic results." *Id.* at 1218.

Here, the short and long trades did not completely offset each other. They were structured so as to have real profit potential, taking into account the closing of both the

[16] There are numerous Circuit Court cases upholding tax strategies characterized by the IRS as shams or tax avoidance, where the trial court was unduly influenced by what it perceived as aggressive tax planning, but where transactions with real economic effect took place. *See Compaq Computer Corp. v. Comm'r*, 277 F.3d 778 (5th Cir. 2001); *IES Indus. Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001); *United Parcel Service v. Comm'r* 254 F.3d 1014 (11th Cir 2001).

[17] Neither did any of the other cases cited by the government, including *Kornman & Assoc., Inc. v. United States*, 527 F.3d 443 (5th Cir. 2008); *H.J. Heinz Co. & Subs v. United States*, 76 Fed.Cl. 570 (2007); *Friedman v. Comm'r*, 869 F.2d 785 (4th Cir. 1989); and *Long Term Capital Holdings*, 330 F. Supp. 2d 122 (D. Conn. 2004). The Fifth Circuit in *Kornman* affirmed the district court's grant of summary judgment against the taxpayer on the ground that a short sale is a liability under § 752. The court did not even consider whether or not the loss was allowable under § 165(a). In *Heinz*, the court held that the relevant transactions "had one purpose, and one purpose alone – producing capital losses … ." Similarly, the courts in *Friedman* and *Long Term Capital* held the transactions at issue were shams. The *dicta* in these cases relied upon by the government must be taken in this context.

long and short transactions.[18]

None of the cases relied upon by the government held that a loss which is not matched by an economic outlay, but results from application of a rule of tax law to transactions with economic substance, is disallowed by § 165(a). The closest cases on point (*Cottage Savings* and *Gitlitz*) rejected the "economic loss" requirement the government advances here.

C. The district court's finding that Sala entered into the Deerhurst Investment for profit within the meaning of § 165(c)(2) is not clearly erroneous.

The government argues that the district court's finding that Sala entered into the Deerhurst Investment with a good faith belief that the venture would create a benefit in excess of the anticipated tax loss "is utterly beside the point." (Aplt. Br. at 58). It states the proper inquiry is whether Sala participated in the Deerhurst GP transaction for the primary purpose of earning an economic profit. It answers its own inquiry "no," ignoring the district court's findings that refute the government's assumptions. Even if the inquiry were as narrowly focused as the government argues it should be: (1) "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." (Aplt.

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[18] The government continues to distort the facts in this case by asserting Sala's actual net profit from the Deerhurst GP transaction was $60,000. (Aplt. Br. at 62-63). The $60,000 profit was the net profit from all the trades in 2000 (including the basis generating trades which the Court found produced a net profit of $90,000 to $110,000) less management fees and other administrative expenses. (Aplt. App. 128; Aplee. Supp. App. 473; 721-722).

App. 140); (2) Sala considered other tax advantaged investments before deciding on Deerhurst, but rejected them because of their low profit potential (*id*. at 137); (3) the trades conducted during the Deerhurst GP period were consistent with Krieger's historical trading strategy – all aimed at making profits (*id*. at 138); (4) the basis generating trades had substantial profit potential and actually made substantial profits (*id*. at 131); and (5) Sala considered profits more significant than tax benefits because he believed tax benefits to be more speculative (*id*. at 137).

The government states Sala "admitted" he understood his 2000 trades would be closed out before the end of the year, regardless of whether it was economically disadvantageous to do so. (Aplt. Br. at 28). Sala did not so testify. He testified it was his understanding that the 2000 trades could be transferred to the new entity, but they were instead liquidated because it would be administratively easier to start a new entity with cash. (Aplee. Supp. App. 476A-476D). Sala's understanding is consistent with the district court's finding of fact that "the liquidation of Deerhurst GP at the end of 2000 had a legitimate business purpose other than the creation of tax losses." (Aplt. App. 133).

Most of the government's arguments that only the Deerhurst GP transactions are relevant in determining profit motive under § 165(c)(2) are the same arguments it made in support of its position that only the Deerhurst GP transactions are relevant in determining economic substance. We will not reiterate our prior response to those arguments. *See* Section I, *supra*. However, the government particularly relies upon *Keeler* in connection with its profit motive argument.

In *Keeler,* the taxpayer argued that straddle trades consisting of stock forward positions generating tax losses were part of his overall trading strategy which involved investments in derivative markets other than the market in which the straddle trades were conducted. This Court noted that the straddle trades were found to be "outside the purview of any general profit motive in the taxpayer's trading," and that the instruments traded in the stock forwards market were not listed on any exchange, registered with the SEC, or sold anywhere outside the highly tax-motivated private market. *Keeler*, 243 F.3d at 1216, 1220.

In contrast, the district court in this case found that the basis trades were consistent with Krieger's past trading in established foreign currency option markets, and had business purpose and economic substance such that they were within the "purview" of the entire Deerhurst Investment.

The government relies on a statement in *Keeler* that, even if the tax motivated trades were part of a taxpayer's overall profit-motivated investment strategy, the "transactions themselves" would have to be profit-motivated to be deductible under § 165(c)(2). 243 F.3d at 1220. However, this statement must be taken in the context of the holding that the tax court correctly considered the taxpayer's trading "on a market with the characteristics of an economic sham." *Id.* It also distinguished cases affirming the tax court's determination that there was a profit motive, including *Stoller v. Comm'r,* 60 T.C.M. (CCH) 1554, 1990 WL 212864 at *14 (U.S.Tax Ct.), *aff'd by* 994 F.2d 885 (D.C. Cir. 1993), because the trading in those cases "occurred on established markets and were

part of a taxpayers' overall profit motivated strategy to hedge their investments." *Keeler*, 243 F.3d at 1220. *Keeler* implicitly recognized *Stoller's* continued validity. *Stoller* held that the court "will look to the overall trading strategy" to determine profit motive. 1990 WL 212864 at *14. It then identified factors that indicated a profit motive: the transactions at issue were embodied in the overall strategy and the trading methods minimized risk. *Id*. at *15.

Since the basis trades here were made in an established market, and involved the same basic strategy as the entire Deerhurst Investment, the government's argument that *Keeler* should have compelled the district court to ignore the overall Deerhurst Investment and focus only upon the Deerhurst GP transaction in determining profit motive has no support in *Keeler*, nor in any other authority cited by the government.

III. The loss is not disallowed by Treasury Regulation § 1.752-6.

A. Introduction.

The government relies on Section 309(c) of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763A-589, 638 (2000) ("§ 309"), which authorizes regulations only in order to prevent "duplication" or "acceleration" of deductions, as authority for implementing Treas. Reg. § 1.752-6(b)(2) ("the Regulation"). Section 1.752-6(b)(2) neither prevents duplication nor acceleration of deductions.

Neither the IRS in Notice 2000-44, nor the government in *Jade Trading* and *Stobie Creek*, argued that the partner's loss generated by the disregard of the sold options in determining partnership basis is not allowable because the partnership obtains a duplicate

deduction when the obligation on the sold option is terminated. In its Proposed Findings of Fact and Conclusions of Law, the government did not argue that there was a double deduction. (Aplee. Supp. App. 69-181). If there were in fact a double deduction, the government would certainly have raised that as additional grounds for disallowance of the claimed loss. It only raises the argument here in a misguided attempt to salvage the Regulation.

Section 309(c) further requires that the partnership rules promulgated by Treasury be "comparable" to the corporate rules. However, § 1.752-6(b)(2)) singles out Notice 2000-44 transactions, and adopts a radically different rule[19] for those transactions. That the treatment of contingent obligations is different under the corporate rules from the special rule for Notice 2000-44 partnerships is vividly illustrated in this case: Sala's basis in Solid (his corporation) is *unreduced* by the short options, because such treatment is permitted by the corporate rules.

Treasury's decision to craft one rule contrary to what had been settled case law for 30 years for a narrowly-defined group of partnership transactions, but to leave the rule in place for corporate transactions and most partnership transactions, could hardly be more arbitrary. There is not a single word in the statute or legislative history indicating that this was Congress's intent.

Particularly in light of the Constitutional limitations on retroactive tax statutes, the government's argument that Congress gave Treasury a blank check to enhance its ability

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[19] The special rules for "Son of Boss" transactions are different from both the corporate rules of § 358(h) and the general rules for partnerships set out in Treas. Reg. § 1.752-6.

to disallow transactions that occurred years in the past simply because Treasury views them as abusive must be rejected.

B. Section 1.752-6(b)(2) is arbitrary.

The rule of law articulated in *Helmer* applied when Sala filed his 2000 income tax return. In 2003, Treasury attempted to *change* the law as it applied to Sala and similarly situated taxpayers. Temporary regulations were issued in 2003 (68 Fed. Reg. 37414), and final regulations were issued in 2005. 70 Fed. Reg. 30334.

The Regulation is nothing more than an attempt by Treasury to strengthen its litigating position in a very narrowly defined set of transactions described by Notice 2000-44.[20]

If valid, the Regulation would require a partner involved in Notice 2000-44 type transactions to reduce his basis in his partnership interest by the amount of any "contingent obligation" assumed by the partnership in a § 721 transaction. However, in a non-Notice 2000-44 transaction, the partner is *not* required to do so. Treas. Reg. § 1.752-6(b)(1). Requiring a basis reduction in a Notice 2000-44 type transaction, where there is no double deduction involved, but not requiring it in other transactions where a duplicated deduction does come into play, is the height of arbitrariness and completely unsupported by the statutory mandate.

[20] Pursuant to Treas. Reg. § 1.752-6, the general rules for partnership obligations (*other than* those described in Notice 2000-44) would permit the loss. Treasury adopted an entirely new and different set of rules to govern the assumption of "contingent obligations" by partnerships occurring on or after June 24, 2003. *See* Treas. Reg. § 1.752-7.

Moreover, despite the preamble stating that it does not follow *Helmer*, the Regulation does not actually change the *Helmer* rule when that rule applies in the government's favor. The Regulation only addresses contingent liabilities that are assumed from a partner in a § 721 transaction (e.g., a contribution of property at the formation of a partnership); other contingent obligations that are subsequently entered into by a partnership, not involving a contribution of property by a partner (i.e., the types of obligations at issue in *Helmer*), are not covered. The Regulation is an unprincipled attempt by the government to make the words of the statute mean one thing when the government is arguing for more taxes (e.g., *Helmer*), but mean an entirely different thing when the same words of the statute are being applied by a taxpayer to reduce its taxes.

As the Supreme Court made clear in striking retroactive regulations in *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204 (1988), "[r]etroactivity is not favored in the law [and] a statutory grant of legislative rulemaking authority will not, as a general matter, be understood to encompass the power to promulgate retroactive rules unless that power is conveyed by Congress in express terms." *Id*. at 208. No such express grant of retroactive authority to alter the longstanding provisions of § 752 exists in this case.

C. The Treasury Department did not have authority to promulgate the regulation under § 309(c) of the Community Renewal Tax Relief Act of 2000.

Section 309 enacted § 358(h) to combat the tax results of corporate transactions, which involved the acceleration and duplication of a loss relating to certain contingent liabilities that are deductible on payment (e.g. medical benefits for retirees) by transferring

those liabilities, along with assets to fund them, to a corporate subsidiary, and then selling the stock in the subsidiary. Both the stock sale and the transferee's payment of the liability can generate a loss for the same item.

Section 309(c), titled "Application of Comparable Rules to Partnerships and S Corporations," directs the Treasury to prescribe rules for partnerships "to prevent the acceleration or duplication of losses … ." § 309(c)(1).

The government agrees that § 1.752-6(b)(2) is valid only if it provides rules comparable to the corporate rules, and prevents acceleration or duplication of losses. (Aplt. Br. at 68, 72, 76-77, 80).

1. The Regulation does not establish a "comparable rule" for Notice 2000-44 transactions.

The district court's conclusion that § 358(h) does not apply to limit Sala's basis in Solid (his S corporation) is undisputed. (Aplt. App. 142). This is because, while the short options would otherwise be treated as a liability under § 358(h)(3) and would therefore reduce Sala's stock basis under § 358(h)(1), § 358(h)(2)(B) makes an exception where substantially all of the assets associated with the contingent liabilities are contributed to the corporation.[21] In this case, Sala transferred long options to Solid at the same time that he transferred the associated short options. (Aplt. App. 142).

However, the Regulation creates a contrary rule in determining Solid's basis in its partnership interest in Deerhurst GP. It does so by creating "an exception to the exception"

[21] Section 309(a) enacted 26 U.S.C. § 358(h) for corporations. Section 309(c) directed Treasury to create comparable rules for partnerships.

provided by § 358(h)(2)(B), solely for transactions described in Notice 2000-44. Treas. Reg. § 1.752-6(b). While the general rule for partners and partnerships incorporates the two corporate exceptions,[22] the special rule Treasury attempted to legislate solely with respect to Notice 2000-44 transactions could hardly be less "comparable" to and less consistent with the rule Congress provided to be applied to corporations and their shareholders.

The government argues that, because the two statutory exceptions set out in § 358(h)(2) are prefaced with the phrase "except as provided by the Secretary," Treasury had authority to ignore the statutory exceptions in devising partnership rules. (Aplt. Br. at 77-78). However, Treasury did not provide any exceptions in the corporate setting, nor did it do so for any partnership transaction except those described in Notice 2000-44. This caused the corporate rules and the special rules of § 1.752-6(b)(2) to be inconsistent and violate the comparability requirement. The government's position that Treasury was given a blank check to modify *any* aspect of the two statutory exceptions for *any* reason (not just to prevent acceleration or duplication of losses) in devising partnership rules, would violate the requirement that the statute provide specific guidance when it delegates to an agency.[23]

Treasury's attempt to promulgate an exception to the statutory exception to be applied only in Notice 2000-44 transactions was an obvious effort to bootstrap its litigating position

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[22] In addition to the exception provided by 26 U.S.C. § 358(h)(2)(B) (where substantially all of the assets with respect to which the obligation are associated are transferred), § 358(h)(2)(A) provides an exception where the trade or business associated with the obligation is transferred to the corporation.

[23] Congress is required to "clearly delineate[] the general policy, the public agency which is to apply it, and the *boundaries of this delegated authority*." *Mistretta v. United States,* 488 U.S. 361, 372-73 (1989) (emphasis supplied.)

with respect to so-called "Son of Boss" cases. When it issued Notice 2000-44, the IRS indicated that it would challenge transactions similar to those described in the Notice. The day following the promulgation of the Regulation, the IRS told its attorneys to use the newly-enacted regulation as a principal ground to challenge taxpayers' claimed losses in so-called "Son of Boss" transactions. Chief Counsel Notice CC-2003-020 (June 25, 2003). Such a procedure is patently improper, and such make-weight regulations are disregarded by the Courts. *See, e.g., Bowen*, 488 U.S. at 213 ("Deference to what appears to be nothing more than an agency's convenient litigating position would be entirely inappropriate.").

2. The contingent liabilities do not cause any "acceleration or duplication of loss."

The Joint Committee on Taxation's General Explanation of § 309 states:

> The Congress was concerned about a type of transaction in which taxpayers seek to *accelerate*, and potentially *duplicate*, deductions involving certain liabilities. As an example, assume a transferor corporation transfers assets with a fair market value basis in exchange for preferred stock of the transferee corporation, plus the transferee's assumption of a contingent liability that is deductible in the future. The transferor claims a basis in the stock received equal to the basis of the assets. However, the value of the stock is reduced by the amount of the liability, creating a potential loss. The transferor may then attempt to *accelerate* the deduction that would be attributable to the liability by selling or exchanging the stock. Furthermore, the transferee might take the position that it is entitled to deduct the payments on the liability, effectively *duplicating* the deduction attributable to the liability.

STAFF J. COMM. ON TAX'N, 107TH CONG., GENERAL EXPLANATION OF LEGISLATION ENACTED IN THE 106TH CONGRESS, (Jt. Comm. Print 2001), at 154 (emphasis supplied).

Unlike the corporate transactions described above, the partnership transactions described in Notice 2000-44 (the target of Treas. Reg. § 1.752-6(b)(2)), do not accelerate or duplicate any loss. Transactions described in Notice 2000-44 result in only a *single* tax loss and that loss is *not accelerated*.

The premier treatise on partnership taxation, William S. McKee, William F. Nelson & Robert L. Whitmire, FEDERAL INCOME TAXATION OF PARTNERSHIPS AND PARTNERS, § 7.04[2] at n.49 (4th Ed. 2007), states:

> The Treasury was authorized to issue Regulations preventing the duplication or acceleration of losses through the assumption of liabilities described in § 358(h)(3). Pub.L. 106-554, § 309(c). Regulations § 1.752-6 prevents deduction of losses that have not been duplicated or accelerated.

In a post-trial brief in *Stobie Creek*, filed on May 15, 2008 (after the district court's opinion in *Sala* had been issued), the government admitted that no duplication or acceleration was involved:

> The fact that these similar sets of rules disallow *single* fictitious losses, as well as the acceleration or duplication of losses, does not invalidate the regulation.

(Aplee. Supp. App. 801) (emphasis supplied).

The government argues that the district court erroneously concluded that Notice 2000-44 transactions do not involve the duplication of losses. (Aplt. Br. at 79-80). The government is wrong.

In this case, Sala contributed long and short positions to Solid, and Solid contributed the positions to Deerhurst GP. When the short positions were terminated, Deerhurst GP did

not claim a loss or deduction for the amount that Sala *initially* received on sale of the options, because, unlike the deductions described by the Joint Committee in the corporate setting, the liquidation of these obligations does not give rise to a deduction.

The government claims that" trading losses" used to offset trading gains were part of a duplication of deductions. (Aplt. Br. at 80). Again, the government is wrong. These gains or losses were based on the changes in value of the options *after* contribution. Accordingly, the fact that there were subsequent trading losses offsetting trading gains does not mean that there was any duplication.

To support its position, the government points to a document which reflects one put spread and one call spread on the Swiss Franc. This document shows that one of the long options generated a trading gain of almost $5 million (sold for $15,017,842.83 less cost of $10,766,872). (Aplt. App. 503). The other long option generated a trading loss of about $2 million (sold at $3,880,061.50 less cost of $6,156,207). The short options associated with the long options moved in tandem with the longs (although, contrary to the government's insinuations, the options were not perfectly balanced), one short option decreasing in value and the other short option increasing in value, with the entire four option group producing a net gain of about $10,000. The fact that there were trading gains and losses *after* contribution does not establish that there was any duplication. Moreover, such gains or losses had no effect on Sala's basis. In fact, if the options had not changed in value at all after contribution, Sala's basis would remain the same (and the same tax result would be obtained), proving that there is no duplication.

The government argues that a partner could "accelerate" future deductions attributable to a contingent liability by immediately selling his interest. (Aplt. Br. at 79-80). However, as the government acknowledges, in the example set out in the legislative history, the obligation assumed is "both contingent and deductible upon payment." *Id.* That is not the situation here: the only transactions subject to the special "exception to the exception" of § 1.752-6(b)(2) (those described in Notice 2000-44) *do not* involve contingent obligations that will generate deductions when they are satisfied.

In *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), the court considered regulations that changed the tax rules for consolidated corporations pursuant to authority in § 1502, which granted Treasury "the power to conform the applicable income tax law of the Code to the special, myriad of problems resulting from the filing of consolidated returns." *Id*. at 1359.

Purporting to rely upon § 1502, Treasury adopted a "duplicate loss rule," (former Treas.Reg. § 1.1502-20 (2005)), which applied to disallow a loss when a parent corporation sold stock in a subsidiary at a loss, and the (former) subsidiary held assets that could later be sold at a loss. *Id.* at 1360. However, non-consolidated corporations could engage in the same transactions, and enjoy the benefit of the so-called "duplicate loss." *Id*. Because the issue addressed in the "duplicate loss rule" was not one of "the problems resulting from the filing of consolidated returns," but rather an artifact of other Code provisions governing the sale of companies with built-in losses, the *Rite Aid* court ruled that the "duplicate loss rule" exceeded statutory authority. *Id.* at 1359-60 ("[I]n the absence of *a problem* created from the

filing of consolidated returns," the Treasury lacks general authority to change the tax rules for consolidated corporations) (emphasis supplied).

Similarly, in this case, Treasury identified no "acceleration or duplication of losses" that generally result from the treatment of contingent liabilities under § 752 as required by the statutory language of § 309(c)(1), which directs Treasury to prescribe rules "to prevent the acceleration or duplication of losses … ." *§* 309(c)(1). In some cases, the treatment of contingent liabilities favors the government (e.g., *Helmer*), and in other cases, the treatment favors the taxpayer. The transactions discussed in Notice 2000-44 did not involve a claimed loss by both the partner and the partnership; only the partner claimed any loss, and there was no potential for a later deduction. Similarly, the assumption of contingent liabilities does not result in the recognition of the loss any earlier than the Code otherwise allows. Thus, "acceleration" and/or "duplication" are simply not at issue.

D. The *CEMCO* case did not address the validity of the Regulation.

The government relies upon *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008). (Aplt. Br. at 71-72). The taxpayer in *Cemco* did not argue that Treasury exceeded its authority in promulgating the Regulation, except to the extent that the regulation was retroactive: "Nor does Cemco argue that any aspect of the regulation, apart from its effective date, is invalid." (Aplee. Supp. App. 738-41). *Cemco* thus did not address the issues of comparability and acceleration/duplication of losses.

The government states that *Cemco* rejected *Klamath's* analysis. (Aplt. Br. at 71-72). *Cemco* mistakenly believed that *Klamath* concluded that § 1.752-6 was authorized by

§ 309(c), but that Treasury had not availed itself of that power. *Cemco*, 515 F.3d at 752 ("The district court in *Klamath* did not doubt that the retroactivity ***could*** rest on the 2000 Act."). *Cemco* misunderstood the *Klamath* decision. *Klamath* did not conclude that "retroactivity *could* rest on the 2000 Act." (emphasis supplied). To the contrary, *Klamath* concluded that the challenged portion of the regulation was *not within* the authority granted by § 309(c). 440 F. Supp. 2d at 621-623.

Cemco did not compare the language of the authorizing statute to the language of the Regulation. Instead, *Cemco* viewed the Regulation as embodying anti-abuse principles, aimed at transactions lacking economic substance. 515 F.3d at 752 ("[A]ll the regulation does is instantiate the pre-existing norm that transactions with no economic substance don't reduce people's taxes."). The district court in this case, like the courts in *Klamath,* 440 F. Supp. 2d at 618 and *Stobie Creek,* 82 Fed. Cl. at 667, examined the regulation in light of the authorizing statute and found it wanting.[24]

Even accepting *Cemco* on its face, i.e., that the regulation "only instantiate[s] the [economic substance rule]," *Cemco* provides no basis for upholding the validity of the Regulation with respect to the transactions in this case, which do have economic substance. (Aplt. App. 159-60).

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[24] Despite finding § 1.752-6 inapplicable, the courts in both *Klamath* and *Stobie Creek* found the transactions at issue lacked economic substance. Unlike *Cemco*, these courts correctly viewed economic substance as a separate inquiry from the validity of the Regulation.

E. The Regulation is not valid as an interpretation of § 752 and is not entitled to retroactive effect.

The government argues in the alternative that the Regulation should be sustained as a regulation interpreting § 752. This is incorrect because: (1) the Regulation does not purport to interpret "liability" as that term is used in § 752; and (2) the Regulation is impermissibly retroactive.

1. Section 1.752-6 does not interpret § 752.

Section 1.752-6 applies only to assumptions of liabilities "other than a liability to which § 752(a) and (b) apply." Treas. Reg. § 1.752-6(a). It creates a new adjustment, which is taken into account *after* the adjustments required by § 752(a) and (b) are taken into account. Thus, § 1.752-6 does not even purport to interpret the term 'liability' as that term is used in § 752(a) and (b). Section 1.752-6 relies entirely upon § 309(c) for its authority.

2. The Regulation violates § 7805(b)'s limits on retroactivity.

The new definition of the term "liability" in the Regulation is also invalid because it is impermissibly retroactive. Congress has generally prohibited Treasury from adopting retroactive rules. Section 7805(b) provides limited exceptions for retroactive rules, and the government attempts to rely on two of those exceptions.

The government points out that § 7805(b)(6) allows the Treasury to make regulations retroactive when Congress has, by separate statute, expressly authorized a retroactive rule. As shown above, however, § 309(c) did not provide such authority.

The government also argues that § 7805(b)(3) authorizes retroactive interpretive rulemaking in this case because it is necessary to "prevent abuse." The positions taken by

taxpayers before the promulgation of the rule were fully consistent with the government's prior position that the term 'liability' in § 752 does not include 'contingent obligations'—a rule that the IRS has long and successfully pressed in litigation that the agency brought to *increase* taxes owed. It cannot be a sufficient basis for a retroactive rule that the agency no longer desires to advance the settled interpretation of a statute that it has successfully urged and that the courts have consistently adopted. It is not an "abuse" to follow the interpretation of the law that the courts have consistently adopted, and apply the law to transactions that have economic substance. Moreover, because it had economic substance, the Deerhurst Investment was not abusive. (Aplt. App. 160).

F. The Regulation violates due process.

An agency's power to promulgate a retroactive rule is also subject to Constitutional limitations. In *United States v. Carlton*, 512 U.S. 26, 32-33 (1994), the Supreme Court held that, under the Due Process Clause, Congress may adopt retroactive tax statutes only when they are rationally related to a valid government purpose and only when the period of retroactivity is "modest."[25] The holding in *Carlton* applies to retroactive regulations as well as retroactive statutes. *Snap-Drape v. Comm'r*, 98 F.3d 194, 203 (5th Cir. 1996).

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[25] The government argues that Sala had notice of the possibility of a change in regulations by virtue of the promulgation of Notice 2000-44. (Aplt. Br. at 6). Treasury did not give taxpayers any notice between December 15, 2000 (the date that § 309 was enacted), and June 23, 2003, that it was considering this type of regulatory change, and the regulation was not finalized until 2005. Moreover, Notice 2000-44 did not suggest that the Treasury was considering a retroactive regulation or discuss the possibility that *Helmer* would be reversed by regulations. Likewise, the legislative history of § 309 did not mention the possibility that the *Helmer* rule would be modified.

Carlton involved a retroactive period of a few months. In her concurring opinion, Justice O'Conner set forth the standard for evaluating such statutes, stating that a retroactive change in a tax law will survive a due process challenge if the law is applied retroactively "for only a relatively short period prior to enactment." 512 U.S. at 38; *see also, Wheeler v. Comm'r*, 143 F.2d 162, 166 (9th Cir. 1944), *rev'd on other grounds*, 324 U.S. 542 (1945) (two year retroactive application of a tax statute was unconstitutional because it had not "come within the next session of the legislature or within a reasonable length of time"); *Darusmont v. Comm'r*, 449 U.S. 292, 296-97 (1938) (upholding 10 month period of retroactivity, but stating that courts have upheld the "customary congressional practice" of limiting retroactive application to the calendar year preceding enactment as "required by the practicalities of producing national legislation").

Section 1.752-6 applies to transactions occurring almost *four years*[26] before its promulgation. The lengthy, multi-year period of retroactivity in this case is more than "modest" and violates the requirements of due process in tax legislation articulated in *Carlton*. Just as Congress could not pass a statute and make it retroactive for such a lengthy period, neither can Treasury make a regulation retroactive for such an extended time frame.

G. If this court holds the Regulation is valid, it should remand.

If the Court were to rule that the Regulation applied to disallow the claimed ordinary loss on the partnership transaction, Sala would still have a capital loss on the liquidation of

[26] If retroactivity is measured from the date that the Regulation was finalized after notice and comment (2005), the delay is almost six years.

his interest in Solid, which would not be disallowed by the operation of § 358(h). Accordingly, if the Court were to conclude that the Regulation applied, it should remand the case for further proceedings to determine the amount of such capital loss.

IV. The district court did not abuse its discretion when it denied the government's motion for new trial.

Standard of review.

This Court reviews the district court's decision denying a motion for a new trial under a "manifest abuse of discretion" standard. *Joseph v. Terminix Int'l Co.*, 17 F.3d 1282, 1285 (10th Cir. 1994). A motion for a new trial "is not regarded with favor and is granted only with great caution, being addressed to the sound discretion of the trial court." *United States v. Page*, 828 F.2d 1476, 1478 (10th Cir. 1987).

A. The government has not demonstrated it meets any of the requirements for a new trial.

For a new trial to be granted, the government must prove: (1) the evidence was newly discovered since the trial; (2) it was diligent in discovering the new evidence; (3) the evidence is not merely cumulative or impeaching; (4) the newly discovered evidence is material; and (5) a new trial, with the newly discovered evidence, will probably produce a different result. *Terminix*, 17 F.3d at 1285. Failure to meet any one of the elements is fatal to the government's case. *Id.*

The district court did not abuse its discretion, explaining in detail why Krieger's May 22, 2008 declaration (the "declaration") purporting to recast portions of his videotaped deposition testimony witnessed by the district court at the trial (Aplt. App.

210-215) failed to meet the five tests required by *Terminix* (17 F.3d at 1285 (10th Cir. 1994)) and why the declaration was not credible.

1. The information in the declaration was not newly discovered and the government failed to act diligently.

On March 5, 2008, the government filed a motion asking the district court to vacate the March 10, 2008 trial date based on a February 27, 2008 letter from J.D. Fischer ("Fischer"), legal counsel for Krieger, indicating that some of the information Krieger provided to the U.S. Attorney's Office for the Southern District of New York ("USAO") may be inconsistent with his deposition testimony. [27] (Aplt. App. 94, 102-03). The USAO interviewed Krieger extensively in 2007 in connection with a potential criminal prosecution of a large accounting firm (*United States v. Coplan*, S.D.N.Y. No. 07-453). At the hearing on the motion, the government trial lawyers (the "Tax Division lawyers") represented that Krieger had already disclosed 95% of the information the government was seeking from him and he would testify if an immunity agreement was reached with the government. (*Id*. at 302). Absent immunity, he would assert his Fifth Amendment rights. (*Id*. at 302). The district court denied the motion. (*Id*. at 104).[28]

On March 11, 2008, the district court rejected the government's attempt to introduce the February 27 letter as evidence at trial for several reasons, including its lack

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[27] Fischer's law firm also represented Krieger at his depositions in the *Sala* case and during his subsequent interviews in 2007 by the USAO.

[28] The government filed numerous motions to delay or postpone the trial of the *Sala* case which were denied by the district court characterizing the government's "repeated efforts to delay, postpone, stay, and otherwise put off the trial of this case" as "troubling." (Aplt. App. 326).

of specific references to inconsistent deposition testimony. (Aplee. Supp. App. 496-501). A day later on March 12, 2008, the third day of trial, the Tax Division lawyers obtained a letter from Fischer which listed excerpts from his deposition transcripts that Krieger believed were inconsistent with the statements he provided to the USAO (the "March 12 letter").[29] (Aplt. App. 220, 223). The letter indicates that the USAO had reviewed the list of excerpts and had suggested additional inconsistencies to Krieger. (*Id*. at 222). The Tax Division lawyers elected not to disclose this letter to the district court. (*Id*. at 326, Aplt. Br. at 15).

Two days prior to the expiration of the 30-day period for the government to move for a new trial, the USAO granted Krieger immunity. The next day, Krieger signed his declaration. (Aplt. App. 211). The declaration states that before and during the *Sala* trial, he authorized Fischer to disclose the existence of inconsistencies to the parties in the *Sala* case. (*Id*.).

The government had the substance of the information in the declaration before completion of the *Sala* trial. The USAO had the information as early as 2007 and the Tax Division lawyers had it no later than March 12, 2008. Both were clearly working in concert and sharing information with one another to defend *Sala*. For example, in March of 2006, before Krieger's deposition was to be taken, an Assistant U.S. Attorney with

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[29] Plaintiff's counsel did not receive either the February 27 letter or the March 12 letter from Fischer. (Aplee. Supp. App. 55). The government promptly alerted Sala's counsel to the existence of the first letter when it sought a continuance, but not to the existence of the second letter. Sala's counsel was unaware of the existence of the second letter until the day before the motion for new trial was filed. (*Id*.).

USAO filed a declaration in support of a motion for a stay, contending that the *Stein* prosecution (S.D.N.Y. No. 05-888) of KPMG-related defendants was somehow connected to the *Sala* case. (Aplee Supp. App at 742-48). The district court found the government's assertions regarding KPMG's involvement in the *Sala* case to be a "red herring." (Aplt. App. 162). The district court denied the motion. (Aplee. Supp. App. 782-83). The Fischer letters and Krieger's declaration reveal that the same USAO and Tax Division lawyers were in communication *through Fischer* about Krieger's interviews and how the information might be helpful to the defense of *Sala*. [30]

The government asserts that the USAO did not disclose Krieger's statements to the Tax Division lawyers for fear of violating grand jury secrecy rules. (Aplt. Br. at 94; Aplt. App. 268-69.) However, the USAO did disclose the information to the Tax Division lawyers by communicating the information through Fischer. Moreover, if the government had granted Krieger immunity before the trial, it could have avoided any possible grand jury secrecy problems relating to his testimony and called him as a witness.

The government argues that the district court clearly erred in its factual finding that the Tax Division lawyers possessed the information contained in the declaration by no later than March 12, 2008, because the letter did not delineate how the referenced deposition excerpts were inconsistent and did not contain admissions sworn under oath by Krieger. (Aplt. Br. at 91). The argument misses the point. The essential question is whether the government can meet its burden that the information in the declaration was

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[30] The issue is not really one of imputing knowledge between the USAO and the Tax Division lawyers. The government is the moving party.

"newly discovered," not how the March 12 letter may have differed to some degree with the declaration or whether Krieger made personal rather than vicarious admissions. Although the government did not procure Krieger's declaration until after the trial, it has submitted no evidence that it was unable to grant immunity and thereby "procure" Krieger's testimony earlier. (Aplt. App. 331-32; Aplt. App. 178-79; Aplt. Br. at 91-92).

More fundamentally, Krieger's unwillingness to testify until granted immunity does not make the information unknown. A witness's post-trial availability does not make his testimony "new." *FMT Corporation, Inc. v. Nissei ASB Co.*, 1995 WL 478853 (N.D. Ga. 1995) (testimony known, but not presented at trial because of a witness's lack of cooperation, is not "newly discovered" evidence). Without citing any legal authority, the government asks this Court to adopt a rule, contrary to *Nissei*, that any time a litigant alleges he was unable to procure the attendance of a witness at trial, but asserts after the trial that the witness is willing to testify, a retrial should be granted. Such a rule is totally contrary to the principles of judicial efficiency and finality of decisions.

The government has also failed to cite any authority that to constitute new evidence, admissions must be personal. Krieger's declaration acknowledges he specifically authorized attorney Fischer to make vicarious admissions in both the February 27 and March 12 letters.

Krieger's declaration and the March 12 letter contain basically the same information. Moreover, the letter discloses the substance of the evidence available to the government. The letter lists and quotes pages of Krieger's deposition transcript that are

inconsistent with statements he made to the USAO and pages that the USAO believed were also inconsistent. The declaration references the same excerpts, then essentially states the opposite of the quoted testimony or attempts to qualify information already in evidence. After comparing Krieger's declaration to all of the evidence and the March 12 letter, the district court found that only one of Krieger's statements was actually "new" information, and the inclusion of this testimony would not have altered the outcome of the case. (Aplt. App. 329-31).

The timing of Krieger's immunity also demonstrates the government was not diligent in procuring his testimony. The government's attempt to use Krieger's temporary residence in Dubai as an excuse for its lack of diligence is unsupported by evidence that his temporary residence impaired granting immunity. It clearly had immediate access to Krieger through Fischer, as evidenced by the timing of Fischer's letters. The USAO could have asked Fischer to disclose the content of both letters much earlier. The government simply chose not to reveal the inconsistencies described in Fischer's March 12, 2008 letter or grant immunity until after the district court issued its Order. (Aplt. Br. at 15; Aplt. App. 326). It did so at its own risk. If a party, through tactical decision, fails to present evidence that was available, it may not seek a retrial using evidence from a claimed newly discovered source. *Lyons v. Jefferson Bank & Trust*, 994 F.2d 716, 728 (10th Cir. 1993).

2. The information was impeaching and cumulative.

The motion for new trial spent two sentences on the requirement that the newly discovered evidence not be "merely cumulative or impeaching." (Aplt. App. 179-80). In

its brief the government argues that the district court erred as a matter of law by concluding that: (1) the declaration was "merely impeaching" (Aplt. Br. at 21); and (2) recantation of prior testimony can never constitute new evidence. (*Id*. at 94-95).

Despite the government's failure to address this requirement in its motion, the district court considered Krieger's entire declaration, and analyzed in detail why his statements were not only impeaching, as they directly disputed, denied or contradicted Krieger's deposition testimony, but why they were also cumulative with other evidence presented in the case. (Aplt. App. 329-31). The district court did not base its ruling on, or even discuss, the legal conclusion that a recantation of prior testimony can never constitute "new" evidence as claimed by the government. It did, however, find that the declaration failed to meet all of the requirements necessary under *Terminix*, and rejected the notion that the government's intention was not to impeach Krieger but rather to present truthful testimony about what transpired. (Aplt. App. 179-80).[31]

Significantly, the government's brief does not bother to address the district court's findings, viewed in conjunction with impeaching aspects of the declaration, that all but one of Krieger's statements were cumulative. The district court's ruling cites eight examples, each with references to specific portions of the trial transcript or the court's opinion, supporting its conclusion that, with the exception of one "new" assertion, the

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[31] Courts are particularly reluctant to grant motions for a new trial when the "newly discovered evidence" consists of witness recantations because they are "looked upon with the utmost suspicion." *Ortiz v. New York City Housing Authority*, 22 F. Supp. 2d 15, 37 (E.D. N.Y. 1998), *quoting United States v. DiPaolo*, 835 F.2d 46, 49 (2d Cir. 1987); *United States v. Stewart*, 433 F.3d 273, 296 (2d Cir. 2006).

statements in Krieger's declaration were cumulative with the evidence already in the record. As to the one exception, dealing with the possibility of separating long and short options, the district court found that it would not produce a different result because Krieger's "new" testimony was unreliable and the government's own expert, DeRosa, disagreed with him. (Aplt. App. 331).

3. The district court's conclusion that Krieger's post-trial statements would not alter the outcome is supported by ample evidence.

When recanted testimony is involved, the critical issue is the credibility of the witness's alleged repudiation of the trial testimony. "The evaluation of the credibility of witnesses is a matter for the trial court, not the appellate court." *United States v. Ramsey*, 726 F.2d 601, 605 (10th Cir. 1984). "When the new evidence consists of a recantation, the trial court must first be satisfied that the challenged testimony was actually false." *Page*, F.2d at 1478. If the court finds that it is the recantation which is false, it need not order a new trial. *Ramsey*, 726 F.2d at 605.

In *Ramsey*, the court remanded because it could not discern from the record whether or how the trial judge evaluated the credibility of [the witness]'s recantation. Here, the record is clear that the district court did not find the declaration credible given the timing and circumstances of its procurement, and the unavoidable appearance that the government used the threat of criminal prosecution to extract statements from Krieger in an attempt to change the outcome of this case. The district court found that the "circumstances leading to the letter were troubling" as "the letter was procured as the

result of a criminal investigation." (Aplt. App. 325-26). Clearly indicating it did not find Krieger's declaration credible, the district court stated, "[e]ven 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." (*Id*. at 331, 559-60).

In *Page*, the Tenth Circuit upheld the trial court's denial of a new trial based on a witness's later recantation because the district court "supported its holding with reasons, as we suggested as the proper course in *Ramsey*." 828 F.2d at 1478-79. Those reasons included the witness's motives in attempting to recant his trial testimony, and the other evidence at trial corroborating the substance of the witness's trial testimony. *Id*. The trial court has wide discretion in determining how the credibility of a witness affects the right to a new trial when a losing party obtains evidence suggesting that a key witness perjured himself at trial. *Malandris v. Merrill Lynch*, 703 F.2d 1152, 1180-1181 (10th Cir. 1981) (*en banc*).

As the district court recognized, the reliability of Krieger's declaration is highly suspect given its timing and the circumstances. However, even if Krieger's declaration is accepted as credible, it says nothing that unequivocally and materially contradicts the district court's findings as to economic substance and Sala's subjective profit motive. Krieger: (1) does not deny that the 24 trades, which produced the tax loss, had a significant profit potential and that Sala actually made money on the trades; (2) does not deny that a significant profit potential existed over the five year term of Sala's investment;

and (3) does not change any of his testimony as to what Sala told Krieger concerning Sala's motivation. (Aplt. App. 102).

The district court did not rely heavily on "eleven direct references" to Krieger's deposition testimony to support Sala's business purpose for the Deerhurst GP transaction as the government contends. (Aplt. Br. at 96). Instead, it received Krieger's deposition testimony "for whatever it's worth." (Aplt. App. 313). All of the direct references to Krieger's testimony in the district court's opinion are either wholly unrelated to the testimony he claimed to have recanted,[32] or are supported by other testimony and documentary evidence. (*Id*. at 129, 131-34).

The government concluded its brief by claiming that the district court denied it a fair trial. However, the government was given every opportunity to prove its case. As evidenced by its fifty-eight page opinion, the district court considered the entire record which encompassed eight days of testimony from numerous witnesses, including the entirety of Krieger's three days of videotaped deposition, [33] and hundreds of exhibits. It then contrasted that evidence with a post-trial declaration, obviously written by government lawyers and obtained as a *quid pro quo* for removing the threat of criminal

[32] For example, Krieger does not recant his testimony that: (1) contributing Solid Currencies to Deerhurst GP allowed for economies of scale; (2) a pool of funds was preferable to numerous individual accounts; (3) larger trades were more attractive to banks and therefore provided better liquidity and lower costs; and (4) Deerhurst GP allowed for trading at higher leveraged basis.

[33] The Tax Division lawyers also had access to Krieger over three days of deposition in October, 2006, and in April, 2007. He was cross-examined about hundreds of documents and all aspects of the Deerhurst Investment.

prosecution. The government appears to have used its "demonstrated power to wield the Sword of Damocles" (Aplt. App. 332) to change a witness's testimony in a civil case with statements not in evidence for the purpose of improperly tainting the district court's opinion in the eyes of this Court. The district court correctly concluded that considering the timing of the motion, the circumstances and content of the declaration and the government's continued efforts to delay the *Sala* case, "a new trial under Rule 59(a) is -- to say the least -- inappropriate." (Aplt. App. 332).

CONCLUSION

This Court should affirm the judgment of the district court.

STATEMENT REGARDING ORAL ARGUMENT

This case involves an issue of first impression in this Circuit, which has been the subject of detailed commentary by academics and tax professionals. The case also involves detailed analysis of the Internal Revenue Code, judicial precedent, and Treasury Regulations. Oral argument is therefore desired.

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Dated this 5th day of June, 2009.

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CERTIFICATE OF SERVICE

This is to certify that, on June 5, 2009, I electronically filed the foregoing PRINCIPAL BRIEF FOR THE APPELLEES using the Appellate CM/ECF system, which will send notification to the following:

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I declare under the penalty of perjury under the laws of the State of Washington and the United States that the foregoing is true and correct.

Dated this 5th day of June, 2009.

/s/ John M. Colvin____________
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