No. 08-1333

**IN THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT**

CARLOS E. SALA, et al.,

Plaintiffs-Appellees

v.

UNITED STATES OF AMERICA,

Defendant-Appellant

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

REPLY BRIEF FOR THE APPELLANT

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INTRODUCTION

Carlos Sala sought to shelter $60 million from income tax by engaging in a series of year-end maneuvers designed by the promoter of the tax shelter to create a $60 million paper loss through the use of offsetting foreign currency options (the "basis-generating trades"). Knowing that the year-end scheme, standing alone, would never survive the gauntlet of statutory, judicial, and regulatory impediments to this kind of chicanery,[1] the promoter packaged it with a long-term investment program to be commenced in the succeeding year. The hope was that a reviewing court would view the abusive tax scheme and subsequent investment program as integrated parts of a single "transaction" for purposes of analyzing the economic substance of, and profit motive with respect to, such "transaction."

The District Court took the bait, brushing aside the decisions of this Court and four other Courts of Appeals that hold that the transaction to be analyzed for these purposes is the *specific* transaction

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[1] See, *e.g., Stobie Creek Invs., LLC v. United States*, 82 Fed. Cl. 636 (2008), *appeal pending*, Fed. Cir. No. 08-5190, and *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11 (2007), *appeal pending*, Fed. Cir. No. 08-5045, in which the courts invalidated essentially the same tax avoidance scheme as the one implemented by Sala here.

generating the claimed tax benefit.[2] The court further held that Treas. Reg. § 1.752-6, which "scupper[s] the entire class of offsetting-option shelters,"[3] is invalid, contrary to the holding of the only Court of Appeals to have addressed the issue. And when Andrew Krieger – the foreign currency trader whose expertise the District Court relied on to support its findings of economic substance and business purpose – recanted, in a post-trial sworn declaration, critical portions of his testimony, the court refused to even hold a hearing on the Government's ensuing motion for a new trial.

In our opening brief, we demonstrated that, once the analysis is properly limited to the discrete, end-of-the-year-2000 transactions that generated the artificial $60 million loss, Sala's claims of economic substance and primary profit motive melt away. We further explained why, in any event, this indisputably non-economic loss is nondeductible as a matter of law under I.R.C. § 165(a). And we refuted each aspect of

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[2] This aspect of the District Court's opinion is now contrary to the decisions of this Court and *five* other Courts of Appeals. *See Klamath Strategic Inv. Fund, LLC v. United States*, 568 F.3d 537, 545 (5th Cir. 2009).

[3] *Cemco Investors, LLC v. United States*, 515 F.3d 749, 751 (7th Cir. 2008), *cert. denied*, 129 S. Ct. 131 (2008).

the District Court's analysis in support of its conclusion that Treas. Reg. § 1.752-6 is invalid. On the procedural side, we demonstrated an abuse of discretion in the District Court's denial of the Government's motion for a new trial in the wake of Krieger's recantation of his prior testimony.

ARGUMENT

A. Taxpayers' analysis of the threshold legal issue that is dispositive of the economic substance determination in this case is plainly erroneous

The main thrust of the Government's economic substance argument is that the District Court erred as a matter of law in evaluating the entire so-called Deerhurst Program, rather than the discrete tax-avoidance scheme that began and ended in late 2000 (the "Deerhurst GP transaction"), for economic substance. *See* Gov't Br. 28-46; *cf. Jeppsen v. Commissioner*, 128 F.3d 1410, 1415 (10th Cir. 1997) (proper scope of "reasonable prospect of recovery" inquiry for purposes of theft-loss deduction under § 165 – specifically, whether a court may consider events that occurred after the year for which the deduction is claimed – is a question of law that is reviewed *de novo*). Taxpayers'

attempted defense of the District Court's analysis of this threshold legal issue falls far short of its intended mark.[4]

1. Taxpayers' assertion that the District Court in fact evaluated the economic substance of the Deerhurst GP transaction "in isolation" is demonstrably wrong

In response to the Government's argument that the District Court erred in not limiting its economic substance analysis to the Deerhurst GP transaction, taxpayers initially claim that "the district court *did* analyze the economic substance of the Deerhurst GP transaction in isolation." Br. 20. Taxpayers are wrong. What the court did was take what it determined to be the maximum after-fee rate-of-return on the basis-generating trades (executed as part of the Deerhurst GP

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[4] Taxpayers devote the first few pages of their economic substance argument to false issues and irrelevant observations. After acknowledging that the proper standard of review is *de novo*, Br. 11-12, they lobby for a "clearly erroneous" standard of review (*id*. at 12). They then carefully distinguish cases that have invalidated offsetting option shelters (*id*. at 13-15), leading to the unremarkable conclusion that "these cases do not establish that, as a matter of law, the transactions generating Sala's basis/loss had no economic substance." *Id*. at 15-16. Finally, they predictably invoke *Helmer v. Commissioner*, 34 T.C.M. (CCH) 727 (1975), as justification for their technical tax position (Br. 16-18), even as they acknowledge elsewhere (*id*. at 14, 15) that *Helmer* has no bearing whatsoever on the economic substance issue.

transaction) and apply it to a $9 million investment (Sala's total commitment) over the 5-year term of the follow-on investment program. Based on that methodology, the court concluded that "Sala's $9 million had the potential to exceed – albeit by a slender margin – the $60,449,984 claimed loss *within the five years and two months dedicated to the combined Deerhurst Program*." (App. 127 [emphasis added].) Thus, the court clearly was evaluating the economic substance of the "combined Deerhurst Program" (App. 127), just as it erroneously held it was required to do.

Significantly, in comparing what it determined to be the maximum potential profit of the "combined Deerhurst Program" (App. 127) to the $60 million claimed loss, the District Court recognized that the economic substance doctrine requires not only that the transaction at issue have a reasonable possibility of profit, but also that the potential profit not be dwarfed by the claimed tax benefits. *See Keeler v. Commissioner*, 243 F.3d 1212, 1219 (10th Cir. 2001) ("the existence of some potential for profit does not foreclose a finding of no economic substance"); *see also Rogers v. United States*, 281 F.3d 1108, 1116 n.4 (10th Cir. 2002); *ACM P'ship v. Commissioner*, 157 F.3d 231, 258 (3d

Cir. 1998). When the analysis is properly limited to the Deerhurst GP transaction, the ratio of the potential profit – even as overstated by the District Court, *see* Gov't Br. 46-50 – to the claimed loss shrinks from roughly 1:1 to less than 1:182.[5] A transaction that is designed to generate a wholly artificial loss that is more than 182 times greater than its maximum potential profit does not have economic substance.

2. Taxpayers add nothing to the District Court's misconceived justification for not limiting its economic substance analysis to the Deerhurst GP transaction

Taxpayers, like the District Court, are unable to articulate a principled explanation why an accepted tenet of the economic substance doctrine – *viz.*, that the transaction to be analyzed for economic substance is the *specific* one that gave rise to the claimed tax benefit – has no applicability to this case. First, they suggest that no such tenet exists (Br. 22). To that end, they make the erroneous assertion (*ibid.*) that the Government's opening brief cites only two cases espousing it –

[5] The District Court determined that the maximum net profit Sala could have realized from the basis-generating trades was approximately $330,000. (App. 127.) That theoretical net profit pales in comparison to the $60 million fictitious loss that the Deerhurst GP transaction was designed to generate for Sala.

James v. Commissioner, 899 F.2d 905 (10th Cir. 1990), and *Klamath Strategic Inv. Fund, LLC v. United States*, 472 F. Supp. 2d 885 (E.D. Tex. 2007). On the contrary, we also cited cases from four other Courts of Appeals: *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1356-57 (Fed. Cir. 2006), *Black & Decker Corp. v. United States*, 436 F.3d 431, 441 (4th Cir. 2006), *Nicole Rose Corp. v. Commissioner*, 320 F.3d 282, 284 (2d Cir. 2003) (per curiam), and *ACM P'ship v. Commissioner*, 157 F.3d 231, 260 & n.57 (3d Cir. 1998). *See* Gov't Br. 24, 34, 36. Taxpayers' failure to acknowledge not only these additional cases, but also the Fifth Circuit's intervening affirmation of this aspect of *Klamath*,[6] speaks volumes.

Taxpayers' attempt to overcome *James* is unavailing. According to taxpayers (Br. 23), this Court in *James* "did not narrowly focus its inquiry as the government argues the district court should have done in this case." But that claim does not square with the Court's unequivocal

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[6] "Various courts have held that when applying the economic substance doctrine, the proper focus is on the particular transaction that gives rise to the tax benefit, not collateral transactions that do not produce tax benefits." *Klamath*, 568 F.3d at 545 (citing *Coltec* and *Nicole Rose Corp.*)

statement that "[t]he only transactions at issue in this case are the purported sales by the [corporations] to the joint ventures [owned by the corporate officers]," *i.e.*, the transactions that gave rise to the claimed tax benefits. 899 F.2d at 910.

Undaunted, taxpayers assert (Br. 23-24) that the very next sentence of the *James* opinion – where the Court remarked that the referenced sales "cannot be legitimized merely because they were on the periphery of some legitimate transactions," 899 F.2d at 910 – aids their case because here, so they contend, the abusive Deerhurst GP transaction and the follow-on, 5-year trading program were integrated, inseparable parts of Sala's overall profit-oriented foreign currency investment strategy. As we demonstrated in our opening brief, however (Gov't Br. 28-31), the phony $60 million tax loss at issue in this case was the result of a discrete transaction that took place near the end of 2000.[7] The Deerhurst LLC, 5-year trading program, on the

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[7] In this regard, it is well-settled that a loss is not considered to have been "sustained" during the taxable year unless the claimed loss results from a transaction that was closed and completed by the end of such year. Treas. Reg. § 1.165-1(b); *see, e.g., Santa Fe Pac. Gold Co. and Subs. v. Commissioner*, 132 T.C. No. 12, 2009 WL 1119371 at *25

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other hand, did not begin until 2001 and was a legitimate foreign currency investment program that had no possibility of generating artificial tax losses.[8] Thus, as was the case in *James*, taxpayers' abusive tax-avoidance scheme, *i.e.*, the Deerhurst GP transaction, "cannot be legitimized," 899 F.2d at 910, merely because it was packaged by the tax shelter promoter with a legitimate investment program that was to commence in the following year.

This Court confirmed this point of law in *Keeler* in rejecting the taxpayer's argument there that his overall profit strategy was sufficient to imbue transactions designed to produce artificial tax losses with a primary profit motive for purposes of I.R.C. § 165(c)(2): "Even if we were convinced that the [tax-motivated] trades were part of taxpayer's overall profit-motivated investment strategy, *the transactions themselves* would have to be profit-motivated in order to be deductible

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[7](...continued)
(2009). Thus, in claiming a $60 million loss on their 2000 tax return, taxpayers necessarily were taking the position that the transaction giving rise to their loss was closed and completed by the end of that year.

[8] Sala incurred substantial *economic* losses – the kind that *are* deductible for tax purposes – as a result of his participation in the follow-on investment program. The IRS did not disallow those losses.

under § 165(c)." 243 F.3d at 1220 (emphasis added). This Court's view of the law on this matter, moreover, is in accord with that of every other Court of Appeals that has had occasion to address the issue. *See Klamath*, *supra* note 2; *Coltec; Black & Decker; Nicole Rose Corp.; ACM P'ship*. The lone authority that taxpayers can muster in their favor is the memorandum decision of the Tax Court in *Salina P'ship LP v. Commissioner*, 80 T.C.M. (CCH) 686 (2000). To the extent that decision can be read as providing any support for the District Court's decision here to lump the year-2000 Deerhurst GP transaction with the Deerhurst LLC, 5-year trading program that began in the following year for purposes of its economic-substance and § 165(c)(2) primary-profit-motive analyses, the decision is contrary to this Court's decisions in *James* and *Keeler* (as well as with the decisions of the other Courts of Appeals cited above) and should, accordingly, be disregarded.

The District Court therefore erred as a matter of law in failing to limit its economic-substance and I.R.C. § 165(c)(2) analyses to the Deerhurst GP transaction – the transaction that indisputably was the sole source of the $60 million fictitious loss that is at issue in this case. And, as explained in our opening brief (Gov't Br. 46-55) and further

demonstrated below, had the District Court properly limited its analysis to the Deerhurst GP transaction, it would have been constrained to conclude that the Deerhurst GP transaction was devoid of economic substance and that Sala was motivated primarily, if not exclusively, by the $60 million in tax losses (producing a tax savings, for his taxable year 2000, of approximately $23 million) that he was promised and that he expected to receive, as opposed to being primarily motivated by the theoretical possibility of realizing a maximum net profit of approximately $330,000.[9]

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[9] Because the design of the Deerhurst GP transaction required that it be terminated by the end of 2000 – without regard to whether it would be economically prudent to close out the basis-generating trades at that time – in order to generate the phony $60 million loss in that year that was the *raison d'être* for the transaction, Sala had no reasonable expectation of realizing the maximum possible net gain of $330,000 with respect to those trades (as calculated by the District Court). In fact, Sala testified (App. 541) that he realized a net profit of only about $60,000 from the Deerhurst GP transaction, and that figure did not take into account, *inter alia*, the $75,000 fee he had paid to obtain a favorable tax opinion letter with respect to his transaction.

B. The Deerhurst GP transaction obviously lacked economic substance

1. Taxpayers misstate the issue

It must first be recognized that the issue here is not, as taxpayers would have it, whether "[t]he basis generating trades had economic substance." Br. 26. Rather, the issue is whether the Deerhurst GP transaction, pursuant to which Sala had to obtain offsetting foreign currency positions and then contribute them to a partnership, which, in turn, had to liquidate within a matter of weeks (before year-end) and had to include at least some noncash property in its liquidating distribution, had economic substance. The record shows that the various steps comprising the Deerhurst GP transaction were designed to produce for Sala a $60 million artificial loss for him in 2000 to offset income in the same amount he had realized in that year from the exercise of stock options. (App. 330-331.) In this regard, the Deerhurst GP transaction was a pre-packaged, Son-of-BOSS scheme that had been identified by the IRS in Notice 2000-44, 2000-2 C.B. 255, as an abusive tax shelter and that operated in essentially the same manner as the similar schemes invalidated by the courts in *Stobie Creek* and

Jade Trading (see note 1, *supra*). *See also Maguire Partners – Master Investments, LLC v. United States*, 2009 WL 279100 (C.D. Cal. Feb. 4, 2009), *appeal docketed*, 9th Cir. No. 09-55650. As was the situation in *Stobie Creek*, *Jade Trading*, and *Maguire Partners*, there was no business reason for Sala to contribute his offsetting foreign currency positions to a partnership that was predetermined to liquidate a few weeks later. The transfer of the currency positions to the partnership and the liquidation of the partnership, however, were critical to generating the $60 million fictitious loss that the Deerhurst GP transaction was designed to produce. *See* Gov't Br. 30-31.

Conversely, the design of the transaction, which required a liquidation of the partnership before year-end, was inimical to the realization of the maximum economic gain from Sala's offsetting foreign currency positions. Depending on the movement of the foreign currencies in relation to the dollar and to one another, Sala had the possibility of incurring a maximum trading loss of approximately $716,000; or, on the upside, he had the possibility of realizing a maximum net gain of $330,000 (as calculated by the District Court). (App. 127.) It was entirely conceivable that, as of the end of 2000, when

the Deerhurst GP partnership had to be liquidated in order to generate the $60 million loss that Sala was promised and that he expected to receive, market conditions would be such that the liquidation of Sala's offsetting currency positions would produce a loss or would otherwise be economically unwise. But a decision to keep the currency positions open beyond the end of 2000 would have eliminated the ability to claim in that year the $60 million artificial loss the transaction was designed to produce, and with it the $23 million in tax savings for Sala's tax year 2000.[10]

There scarcely could be a more obvious example of a transaction devoid of economic substance than the Deerhurst GP transaction – a transaction whose maximum, theoretical net profit ($330,000) not only was merely a little over one-half of one percent of the fictitious tax loss ($60 million) it was designed to produce, but whose required operation was inimical to the realization of even that relatively paltry profit. It is

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[10] Sala admitted in his testimony that he understood that his currency positions would have to be liquidated before the end of 2000 to generate in that year the $60 million in paper losses that he was seeking (App. 547, 548-549), and the District Court found that Sala's Deerhurst GP account "was intended from inception to be liquidated at the end of 2000." (App. 330.)

no wonder that every court, save the District Court here, has found the offsetting-option tax-avoidance scheme at issue here to be devoid of economic substance. *See Stobie Creek; Jade Trading; Maguire Partners; see also Rogers*, 281 F.3d at 1116 n.4; *Keeler*, 243 F.3d at 1219; *ACM P'ship*, 157 F.3d at 258 (possibility that a transaction could generate a profit that is dwarfed by the tax benefits the transaction was designed to create is not sufficient to imbue the transaction with economic substance).[11]

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[11] Taxpayers devote several pages of their brief (Br. 28-31) to an attempted defense of the District Court's calculation of Sala's fees and its resulting determination that Sala had the possibility of realizing a maximum net gain of $330,000. Their argument is not well-founded for the reasons set forth in our opening brief. *See* Gov't Br. 46-50. We add here that, according to Krieger's own testimony, the contractual mark-up fees amounted to $150 per $1 million traded (not $15, as taxpayers assert, Br. 30) and applied to the face amounts of the trades (not the much lower premiums, as the District Court erroneously surmised, App. 127). (Supp. App. 685-685A.) Thus, depending on the number of sides of each four-sided trade that were contractually subject to the fee, the contractual mark-up fee with respect to the basis-generating trades was either approximately $500,000, $250,000, or $125,000, not $9,000 as the District Court concluded or $11,700 as taxpayers assert. More importantly, taxpayers' argument in this regard is beside the point since, as we have demonstrated above and in our opening brief (Gov't Br. 51-55), even assuming, *arguendo*, that the Deerhurst GP transaction had the theoretical possibility of producing a maximum net profit of $330,000, the transaction nevertheless clearly was devoid of

(continued...)

2. There were no "business reasons" for the pre-planned, unconditional liquidation of the basis-generating trades prior to the end of 2000

Taxpayers implicitly concede, as the District Court found (App. 330), that Sala's Deerhurst GP account "was intended from inception to be liquidated at the end of 2000." They nevertheless contend (Br. 32-33) that the District Court correctly found that there were "business reasons" for this pre-ordained decision to close out Sala's foreign currency positions before the end of 2000. Taxpayers' argument is nonsensical as well as internally inconsistent. Taxpayers' fundamental argument is that Sala entered into the Deerhurst GP transaction for the purpose of realizing an economic profit from his offsetting foreign currency positions. But no rational person having the goal of realizing a profit from the currency trading positions at issue in this case would agree, at the time he acquired the positions, to their liquidation a few weeks later (before the end of 2000) without regard to whether such liquidation would be economically prudent. But that is exactly what Sala did in this case. If Sala actually had been motivated by profit, he

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[11](...continued)
economic substance.

would not have agreed in advance to the liquidation of his positions before the close of 2000 but, instead, he would have analyzed his positions at year's end and *then* made a decision as to whether it would be economically advantageous to close out the positions or to hold them open into the following year. Taxpayers are unable to offer any explanation as to why Sala would have committed himself to liquidating his positions by the year's end, even if such liquidation would have been economically unwise, if his motivation for the Deerhurst GP transaction was profit. Sala's actions, however, hardly were irrational. He understood full well, as he testified (App. 547, 548-549), that liquidation of his currency positions before the end of 2000 was essential to his achievement of the $60 million paper loss he was promised and that he expected to receive.

We would further point out that the District Court's finding that there were business reasons for the pre-determined decision to close out Sala's Deerhurst GP account by the end of 2000 is based largely on the testimony of Andrew Krieger, the foreign currency trading expert who

executed all the trades in issue.[12] Although Krieger testified that there were various business reasons for closing out the currency positions by the end of 2000, he specifically recanted that testimony in his post-trial sworn declaration. (App. 210-215.) In that declaration, which formed the basis for the Government's unsuccessful motion for a new trial, Krieger stated that there were no business reasons for liquidating the trades by the end of the year and that he did so because the promoter told him that such liquidation was essential to obtaining the tax losses that the Deerhurst GP transaction was designed to produce. (App. 214.) There is, accordingly, no credible evidence supporting the District Court's finding that there were business reasons for the pre-ordained liquidation of the currency positions by the end of 2000.[13]

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[12] Sala's corroborating testimony on this point has no probative value, as he simply parroted what was "told to" him by Krieger and the promoter. (Supp. App. 476B.)

[13] The purported business reasons cited by Krieger in his subsequently recanted testimony are patently make-weight claims. Thus, for example, vague notions that liquidating the trades served to protect against year-end "illiquidity" and "volatility" (App. 132) make no sense, since it was predetermined that the currency positions would be closed out before the end of 2000 without regard to the extant market conditions. (App. 330.) The District Court's indication (App. 133) that the pre-conceived, year-end liquidation of the trades served

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C. Taxpayers' claimed fictitious $60 million loss is barred by I.R.C. § 165

1. Taxpayers' claimed loss was not "sustained" within the meaning of I.R.C. § 165(a) and the regulations thereunder

As we demonstrated in our opening brief (Gov't Br. 60-63), the $60 million loss at issue is a wholly artificial, paper loss and, as such, does not constitute a deductible, *bona fide* loss that was actually sustained. Treas. Reg. § 1.165-1(b); *see Keeler*, 243 F.3d at 1218; *ACM P'ship*, 157 F.3d at 252. Taxpayers' assertion (Br. 34-35) that the Government failed to properly raise the § 165(a) argument in the District Court is meritless. The Government asserted in its opening statement at trial (App. 533-534) that taxpayers' claimed loss was barred by § 165(a), and taxpayers did not object to the presentation of that argument. In any event, the Government's § 165(a) argument is

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[13](...continued)
the purpose of capturing positive (gross) returns suffers from the same illogic: the trades were pre-planned to be liquidated by year's end regardless of the economic effect of such liquidation. (App. 330.) And, of course, *Krieger* admitted in his sworn, post-trial declaration that there were no business reasons for liquidating the trades by the end of 2000 and that the liquidation was done solely to obtain the artificial tax losses the Deerhurst GP transaction was designed to generate.

founded on the undisputed fact that there is no economic content whatsoever to taxpayers' claimed $60 million loss, *i.e.*, that the loss is wholly artificial.[14] The issue before this Court is thus one of law as to which taxpayers have had a full and fair opportunity in their brief to this Court to present their position.[15] In these circumstances, consideration of the argument by this Court is entirely appropriate. *See United States v. Hardman*, 297 F.3d 1116, 1123-24 (10th Cir. 2002) (*en banc*).

On the merits, taxpayers' attempt (Br. 35-40) to demonstrate that their claimed $60 million loss is a bona fide loss within the meaning of § 165(a), notwithstanding that the "loss" was wholly devoid of any economic content, is hardly persuasive. For example, their attempt to

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[14] Sala's testimony at trial that he realized a net gain of about $60,000 from the Deerhurst GP transaction (App. 541) confirms that the $60 million loss that taxpayers reported on their return as having been incurred in that transaction is a complete fiction.

[15] Taxpayers misleadingly cite *Jeppsen v. Commissioner*, 128 F.3d 1410 (10th Cir. 1997), for the proposition that "whether a loss has been 'sustained' under § 165(a) presents mixed questions of law and fact." Br. 33. *Jeppsen* involved the issue of *when* a theft loss is sustained, not *whether* such a loss has economic content. And, there is no factual dispute here that taxpayers' claimed loss was wholly devoid of any economic content.

compare their fictitious loss to the deduction for depreciation allowed under the Code is wholly misconceived. First, depreciation deductions entail no loss and hence are governed by I.R.C. §§ 167 and 168, not § 165. Further, the allowance for depreciation merely allows a taxpayer to recover, over a period of years, his *economic* cost of acquiring a depreciable asset used in his trade or business.[16]

Taxpayers' attempted reliance on *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), is similarly misplaced as the decision there in no way sanctions the deductibility of a wholly artificial loss stemming from a transaction specifically entered into for the purpose of generating the claimed loss. Moreover, taxpayers' assertion that the S-corporation *operating* losses at issue in *Gitlitz* "had to qualify under § 165(a)" in order to be deductible, Br. 37 & n.15, is wrong. An S-corporation operating loss merely represents the excess of the corporation's

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[16] Taxpayers' suggestion that the statutory step-up in basis for inherited property somehow supports their position, Br. 36 n.14, is ludicrous. I.R.C. § 1014 serves to prevent the same appreciation in property value from being taxed both for estate tax purposes and income tax purposes. Congress did not thereby sanction the deduction of non-economic losses purportedly generated through manipulation of the basis rules applicable to partnerships.

operating deductions for the year (*e.g.*, ordinary and necessary business expenses under § 162) over its gross operating income for the year, which the shareholders then take into account in determining their taxable income for the year. *See* I.R.C. § 1366(a)(1)(B). In contrast, § 165 applies to losses that are occasioned by an identifiable event, such as a sale of property or a theft of money. *See* McCoy, 527-3rd T.M., *Loss Deductions*, at A-3.

There is, moreover, no inconsistency between the Government's argument and the Supreme Court's decision in *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991). There, it was undisputed that the claimed loss represented an actual decline in the value of the subject property between the date of the taxpayer's acquisition of the property and the date of its purported disposition. The issue before the Court was whether the taxpayer's exchange of the subject property for similar property was an appropriate occasion to recognize the economic loss for tax purposes. *See* Treas. Reg. § 1.1001-1(a). The Court's affirmative response to that question provides no support for taxpayers' attempt here to deduct an entirely fictitious loss.

2. Because Sala's motivation for participating in the Deerhurst GP transaction was primarily, if not exclusively, the $60 million artificial loss that he expected to receive, taxpayers' claimed loss is barred by I.R.C. § 165(c)(2)

Just as the transaction to be evaluated for economic substance is the one that generated the claimed tax benefit, so, too, the transaction to be evaluated for profit motive under § 165(c)(2) is the one that generated the claimed loss. *See Keeler*, 243 F.3d at 1220. That transaction in this case is the Deerhurst GP transaction. *See* Gov't Br. 28-32. And, as even the District Court recognized (App. 129, 137), only a *primary* profit motive will suffice under § 165(c)(2). *See Miller v. Commissioner*, 836 F.2d 1274, 1278 (10th Cir. 1988).

Taxpayers can make no plausible argument that Sala's primary motivation for participating in the Deerhurst GP transaction was the theoretical possibility of making a maximum net profit of $330,000, and not the $60 million artificial loss (producing a tax savings of $23 million) that the Deerhurst GP transaction was designed to generate. Indeed, as demonstrated above, that Sala understood from the inception of the transaction that his currency positions would be closed out by the end of 2000 in order to generate the loss he sought,

without regard to whether such a year-end liquidation would be economically prudent (App. 330), establishes that Sala's sole motivation for the transaction was the artificial loss he sought to obtain. It therefore follows here that taxpayers' claimed loss from the Deerhurst GP transaction is barred by I.R.C. § 165(c)(2) without regard to whether that transaction had any economic substance. *See Keeler*, 243 F.3d at 1220; *Miller*, 836 F.2d at 1278.

D. The District Court erred in invalidating Treas. Reg. § 1.752-6

1. Taxpayers' argument that § 1.752-6 falls outside the rulemaking authority granted by Congress in 2000 does not withstand scrutiny

In 2000, Congress enacted I.R.C. § 358(h) and directed the Secretary to promulgate comparable rules in the partnership context "to prevent the acceleration or duplication of losses" through liability assumptions in transactions involving partnerships. Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, § 309(c), 114 Stat. 2763A-587, 638 (the "Act"). Taxpayers' argument that the Secretary's response to this directive, Treas. Reg. § 1.752-6, is not "comparable" to § 358(h), Br. 47-48, is meritless. Section 358(h)(2), which is prefaced by

the clause "Except as provided by the Secretary," sets forth two exceptions to the basis-reduction rule of § 358(h)(1). Section 1.752-6 carved out an exception to one of those exceptions (§ 358(h)(2)(B)) in the case of Notice 2000-44 transactions. *See* Treas. Reg. § 1.752-6(b)(2). As we stated in our opening brief, "[i]nasmuch as Congress expressly authorized the Secretary to alter the § 358(h)(2) exceptions in the corporate context, it is nonsensical to suggest that Congress's call for comparable rules in the partnership context – set forth in the very same Act § 309 – would not include the same authority to alter the § 358(h)(2) exceptions." Gov't Br. 77-78.

We also demonstrated in our opening brief (Gov't Br. 79-80) that "§ 1.752-6 indisputably prevents the acceleration of losses described in the legislative history of Act § 309." *Id.* at 80. Taxpayers implicitly concede this point, merely asserting (Br. 52) that the only transactions that are subject to the regulation by dint of the "exception to the exception" set forth in § 1.752-6(b)(2) – *i.e.*, transactions described in Notice 2000-44 – never entail the type of loss-acceleration described in the legislative history. Even if that were correct, taxpayers do not purport to explain how that circumstance would counteract the

relevant consideration here, *viz.*, that § 1.752-6 indisputably prevents the acceleration of losses described in the legislative history.[17] For that reason, taxpayers' response (Br. 50-51) to our contention that § 1.752-6 also prevents the duplication of losses in this case, Gov't Br. 80, is beside the point.

2. Taxpayers misconstrue both *Rite Aid* and *Cemco*

Taxpayers' attempt to garner support from *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), Br. 52-53, is ineffectual. In *Rite Aid*, the Federal Circuit held that, in promulgating the "duplicate loss" rule of former Treas. Reg. § 1.1502-20, the Secretary exceeded the authority delegated by Congress in I.R.C. § 1502 to issue regulations dealing with consolidated returns. The court reasoned that, whereas § 1502 gives the Secretary authority "to correct problems created from the filing of consolidated returns," the "duplicate loss" problem targeted by § 1.1502-20 "is not a problem resulting from the

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[17] Taxpayers' repeated insistence (Br. 50-53) that Notice 2000-44 transactions do not involve the acceleration or duplication of losses is irrelevant, since § 1.752-6 is not limited to Notice 2000-44 transactions. *See* Gov't Br. 78-79. Moreover, that § 1.752-6 may disallow single fictitious losses, as well as prevent the acceleration or duplication of losses, does not invalidate the regulation.

filing of consolidated income tax returns." 255 F.3d at 1359, 1360. In contrast, Act § 309(c) identified a problem resulting from contribution-assumption transactions involving partnerships – the acceleration or duplication of losses – and directed the Secretary to correct it. And, as indicated above, taxpayers do not dispute that § 1.752-6 prevents the acceleration of losses described in the legislative history.

Taxpayers' attempt (Br. 53-54) to dismiss the Seventh Circuit's decision in *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008), *cert. denied*, 129 S. Ct. 131 (2008), is understandable, but hardly persuasive. As explained in our opening brief (Gov't Br. 71-73), the Seventh Circuit in *Cemco* held that, in accordance with I.R.C. § 7805(b)(6), the retroactive effective date of Treas. Reg. § 1.752-6 is valid because the Secretary promulgated the regulation pursuant to the Congressional grant of authority set forth in Act § 309(c)(1). 515 F.3d at 752. In this regard, the Court of Appeals expressly rejected the contrary holding of the district court in *Klamath*, upon which the District Court here relied heavily. *Ibid*. Indeed, the Seventh Circuit was baffled by the *Klamath* court's conclusion (followed by the District Court here) that § 1.752-6 was not promulgated pursuant to Act

§ 309(c)(1), since, the Court stated, the regulation clearly "applies to partnerships … a rule 'similar' to the approach that Congress adopted for other business entities" in the same legislation. *Ibid.* In short, the District Court's decision in this case flies in the face of the Seventh Circuit's decision in *Cemco*.

3. Taxpayers' due process argument is meritless

Taxpayers' half-hearted appeal to the Constitution falls flat. The Supreme Court "repeatedly has upheld retroactive tax legislation against a due process challenge." *United States v. Carlton*, 512 U.S. 26, 30 (1994). Moreover, at least two lower courts have expressly upheld retroactive regulations against due process challenges. *See Tate & Lyle, Inc. v. Commissioner*, 87 F.3d 99, 107 (3d Cir. 1996); *A. Tarricone, Inc. v. United States*, 4 F. Supp. 2d 323, 327 (S.D.N.Y. 1998).

The Partnerships' sole contention in this regard (Br. 57) – that the period of retroactivity of § 1.752-6 is unconstitutionally long – does not hold water. The period of retroactivity in this case is approximately 3-½ years (October 1999 to June 2003). This period of retroactivity was necessary to stem the vast amount of abuse attributable to Son-of-BOSS transactions. Indeed, in Act § 309(d)(2), Congress expressly

authorized the Secretary to issue regulations retroactive to October 19, 1999. There can hardly be a due process violation when the Secretary, at Congress's direction, issues retroactive regulations to combat tax abuse involving liability assumptions by partnerships, and chooses as the effective date for such regulations the specific date that Congress indicated would be appropriate. *See Cemco*, 515 F.3d at 752.

Moreover, courts have upheld the retroactive application of tax regulations and rulings for periods exceeding the period at issue here. *See Tate & Lyle*, 87 F.3d at 108 (6 years); *E.I. du Pont de Nemours & Co. v. Commissioner,* 41 F.3d 130, 133, 140 (3d Cir.1994) (12 years); *Rutter v. Commissioner,* 760 F.2d 466, 468-469 (2d Cir.1985) (5-year retroactive application of revenue ruling). Thus, the retroactivity of § 1.752-6 is constitutional.

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

As we demonstrated in our opening brief (Gov't Br. 93-94), the District Court, in rejecting the Government's argument that Krieger's sworn recantation of his trial testimony constituted evidence newly discovered since trial and that the Government had acted diligently in

discovering it, improperly imputed the knowledge of federal prosecutors in the U.S. Attorney's office for the Southern District of New York to the Tax Division's civil trial attorneys. Taxpayers' attempted defense of the District Court's ruling is nonresponsive to the Government's argument: "The issue is not really one of imputing knowledge between the USAO and the Tax Division lawyers. The government is the moving party." Br. 61 n.30. This purported rejoinder ignores, *e.g.*, the reams of caselaw under Fed. R. Crim. P. 6(e) regarding the limited circumstances under which a Government attorney may disclose grand jury information to another Government attorney (particularly one not involved in criminal matters).

The District Court's conclusion that the Government trial attorneys did not act diligently in bringing Krieger's recantation to the court's attention is baffling, given the fact that those attorneys immediately alerted the court to the February 27 letter from Krieger's counsel (Fischer) indicating that Krieger's prior testimony was unreliable and, on that basis, requested a postponement of the trial until such time as Krieger would agree to testify at the trial. (App. 94-103.) As Government counsel stated at the ensuing hearing on the

motion to vacate the trial, "[s]ometimes … courts are confronting this after the fact, Rule 60, but here we have the opportunity to address it beforehand." (App. 305.) Yet the District Court chose to ignore the problem because, in its words, "it's time to reap and it is time to sow, and that time has arrived in this case." (App. 313.)[18]

Taxpayers seek to defend the District Court's refusal to consider Krieger's recantation on the ground that the statements therein were impeaching *on their face*. That, of course, is true of all witness recantations. The law of this Circuit is clear on this point: a trial judge normally must convene a hearing to determine the credibility of a recanting, material witness.[19] *See United States v. Page*, 828 F.2d 1476, 1478 (10th Cir. 1987); *United States v. Ramsey*, 726 F.2d 601, 604-05 (10th Cir. 1984); *see also Malandris v. Merrill Lynch*, 703 F.2d 1152,

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[18] Taxpayers' implication (Br. 60 n.29) that the Government withheld Fischer's March 12 letter from them is outrageous, given that the letter was addressed to counsel for both parties. (App. 220, 258 n.6.) The Government's reasons for not alerting the *District Court* to the March 12 letter are fully set forth in our opening brief (Gov't Br. 15-16, 92-93).

[19] Of course, no such hearing would be necessary if this Court were to reverse the District Court's judgment on the basis of any of the Government's other arguments in this case.

1180-81 (10th Cir. 1981) (*en banc*). Taxpayers do not even mention this aspect of the foregoing cases, much less attempt to justify the District Court's departure from the normal course.

Finally, taxpayers' contention that the statements in Krieger's post-trial declaration were not material to the District Court's decision, Br. 65-67, is pure fantasy. The two key witnesses in this case were Sala and Krieger. It was Krieger's well-established reputation as foreign currency trader *extraordinaire* that taxpayers relied on heavily in arguing that Sala was motivated primarily by the prospect of reaping large economic gains through Krieger's trading expertise. (App. 137-140.) The notion that Krieger did not recant any testimony that was material to the District Court's findings regarding economic substance and profit motive is preposterous.[20]

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[20] For instance, taxpayers claim (Br. 67 n. 32) that Krieger did not recant his testimony that "contributing Solid Currencies to Deerhurst GP allowed for economies of scale" and that "a pool of funds was preferable to numerous individual accounts." Yet Krieger unequivocally states in his post-trial declaration that "[t]he transactions that gave rise to the tax losses, *including the structure imposed on the participants and the use of an S corporation and a general partnership*, were not designed to assist in the creation of a profit or for any purpose other than the creation of tax losses." (App.

(continued...)

CONCLUSION

For the reasons stated above and in the Government's opening brief, this Court should reverse the judgment of the District Court in its entirety. In the alternative, the Court should remand the case for a new trial.

Respectfully submitted,

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JULY 2009

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[20](...continued)
214 [emphasis added].) Similarly, Krieger states in his post-trial declaration, directly contrary to his trial testimony, that the liquidation of the Deerhurst GP trades at the end of 2000 served no business purpose and was done only to produce the artificial tax losses at issue in this case. (App. 214.)

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