Nos. 09-72457 and 09-72458

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

HENRY SAMUELI; SUSAN F. SAMUELI,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

PATRICIA W. RICKS; THOMAS G. RICKS,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

BRIEF FOR THE APPELLEE

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GLOSSARY OF ABBREVIATIONS AND ACRONYMS

AAA	The highest rating for securities (indicating the lowest risk of borrower default)
Freddie Mac	Federal Home Loan Mortgage Corporation
FSA	IRS Field Service Advisory
GCM	IRS General Counsel Memorandum
LIBOR	London Inter Bank Offered Rate
NASDAQ	National Association of Securities and Dealers Automated Quotation
PLR	Private Letter Ruling (an IRS administrative ruling)
SEC	Securities and Exchange Commission
STRIP	Separate Trading of Registered Interest and Principal of Securities

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BRIEF FOR THE APPELLEE

STATEMENT OF JURISDICTION

On April 27, 2006, the Commissioner of Internal Revenue issued a notice of deficiency to Henry Samueli and his wife, Susan F. Samueli, determining a deficiency in income tax of $2,177,532 for their 2001 tax

year and a deficiency of $171,026 for their 2003 tax year. (ER 37.)[1] The Samuelis filed a timely petition in the Tax Court on July 19, 2006, challenging the Commissioner's determination. (ER 119.) In addition, on April 28, 2006, the Commissioner issued a notice of deficiency to Thomas G. Ricks and his wife, Patricia W. Ricks, determining a deficiency in their income tax of $6,126 for their 2001 tax year. (ER 55.) The Rickses filed a timely petition in the Tax Court on July 24, 2006, challenging the Commissioner's determination. (ER 123.) The Tax Court had jurisdiction over both petitions pursuant to Internal Revenue Code (I.R.C.) (26 U.S.C.) §§ 6213(a) and 7442.

On May 19, 2009, the Tax Court entered a final, appealable decision in each case. (ER 6, 7.) The Rickses filed a timely notice of appeal to this Court on July 27, 2009. (ER 4.) The Samuelis filed a timely notice of appeal to this Court on July 28, 2009. (ER 2.) *See* I.R.C. § 7483. This Court has jurisdiction pursuant to I.R.C. § 7482.

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[1] "ER" references are the pages of the appellants' Excerpts of Record. "SER" references are to the pages of the Supplemental Excerpts of Record filed together with this brief.

STATEMENT OF THE ISSUES

1. Whether the financial transactions in which the Samuelis and the Rickses (collectively, "taxpayers") engaged between 2001 and 2003 qualify as a securities lending transaction under I.R.C. § 1058.

2. Whether taxpayers are entitled to their claimed interest deductions for certain amounts paid in connection with their transactions.

STATEMENT OF THE CASE

The Commissioner determined that agreements governing a leveraged bond transaction between taxpayers and a brokerage firm did not satisfy the statutory requirements for nonrecognition of gain or loss on the loan or return of the bond (*see* I.R.C. § 1058), disallowed certain interest deductions, and adjusted the tax consequences of the transaction accordingly. (ER 44, 60.) Taxpayers filed petitions in the Tax Court challenging the Commissioner's determinations, and the cases were consolidated. (ER 119, 123.) The Samuelis filed a second amendment to their petition, raising new issues regarding unrelated partnership items for their 2003 tax year. (ER 120.) Taxpayers then moved for summary judgment. (ER 120.) The Commissioner opposed, moved for partial summary judgment, and moved to dismiss for lack of

jurisdiction with respect to the unrelated partnership issues raised by the Samuelis. (ER 121-122.)

In an opinion published at *Samueli v. Commissioner*, 132 T.C. No. 4 (2009), the Tax Court (Judge Kroupa) agreed with the Commissioner that the transaction did not qualify for nonrecognition treatment under I.R.C. § 1058 and that taxpayers were not entitled to the claimed interest deductions, and thus denied the taxpayers' motions for summary judgment and granted the Commissioner's motion for partial summary judgment. In a second opinion, published at *Samueli v. Commissioner*, 132 T.C. No. 16 (2009), the Tax Court (Judge Kroupa) granted the Commissioner's motion to dismiss with respect to the unrelated partnership issues raised by the Samuelis. The Tax Court then entered decisions sustaining the Commissioner's asserted tax deficiencies. (ER 6, 7.)

Taxpayers filed notices of appeal from the respective decisions of the Tax Court, specifying that they were appealing "in particular" from the Tax Court opinion denying their motion for summary judgment and granting the Commissioner's motion for partial summary judgment. (ER 2, 4.)

STATEMENT OF FACTS

A. The taxpayers

Henry Samueli is the co-founder of Broadcom Corporation, a publicly traded company listed on the NASDAQ Exchange. (ER 63.) He and his wife, Susan Samueli, conduct their business affairs through H&S Ventures LLC, a limited liability company. (ER 64.) H&S Ventures is owned 10 percent by Henry Samueli, 10 percent by Susan Samueli, and 80 percent by the Shiloh Trust, a grantor trust created by the Samuelis. (ER 64.) For federal income tax purposes, the Shiloh Trust is a disregarded entity (ER 64; *see* I.R.C. § 671) and H&S Ventures is a pass-through entity (ER 64; *see generally* I.R.C. §§ 6221 *et seq*.). Accordingly, investments made and income received by Shiloh or H&S Ventures are attributed to the Samuelis.

Thomas Ricks was at all relevant times the Chief Investment Officer for H&S Ventures. (ER 64.) He became an investor in the transaction in issue by purchasing a relatively small (0.2 percent) interest in the transaction from H&S Ventures. (ER 74.)

B. The transaction (as conceived)

In 2001 Ricks advised the Samuelis to enter into certain financial transactions that would produce economic gains if interest rates

continued to decline. (SER 2.) In particular, he recommended a transaction in which the Samuelis would purchase an "agency strip" — *i.e.*, an interest in the principal portion of a bond issued by a federal agency, but not in the interest payments that might otherwise be associated with the bond — and finance the purchase price of the strip with a variable rate margin loan.[2] (*Id.*)

As Ricks explained, with an agency strip the rate of return "is equal to the rate at which the purchase price is discounted from the strip's par value due at maturity" and thus "is fixed at the date of purchase" with "no risk that the rate of return on the strip will decline over the holding period."[3] (SER 4.) On the other hand, "[t]he interest rate . . . on the margin loan . . . is not fixed throughout the holding period." (*Id.*) Accordingly, "[t]he return on this transaction is dependent on the movement of the short term borrowing rate after the agency strip is purchased." (SER 3.) If the short-term borrowing rate remained below the fixed rate of return on the strip, then the Samuelis

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[2] "Strip" is an acronym for Separate Trading of Registered Interest and Principal of Securities. (ER 67.)

[3] Ricks also believed that, because of Freddie Mac's stability and AAA rating, "[t]he risk of principal loss from borrower default on the strip is remote." (SER 5.)

would earn a profit — and the lower the interest rate fell, the greater their profit would be. (*Id.*) On the other hand, if interest rates did not fall, they would lose money. As Ricks explained, "borrowing costs will have to decline by at least .19% in November or December [2001] for the transaction to break even." (SER 4.)

Ricks prepared his recommendation to the Samuelis after consultation with Katherine Szem, a tax partner with Arthur Anderson, and Thomas Boczar, Director of Marketing for Financial Institutions at Twenty-First Securities. (ER 65-66.) Pursuant to a summons, Twenty-First Securities subsequently produced to the IRS "a marketing piece," specifically, "the one page write up that Twenty-First Securities typically uses in connection with" transactions such as "the leveraged bond transaction executed by the Shiloh Trust," and which Twenty-First Securities was using "at the time of" that transaction. (SER 13.)

In that marketing write up, Twenty-First Securities described "a transaction . . . designed to allow an investor to earn significant profits from movements in short-term interest rates." (SER 15.) As in the case of a fixed-rate security purchased with a variable-rate margin loan, the "[e]conomic[]" benefits of the transaction — *i.e.*, the

opportunity to earn profits — stem from the fact that "the investor is earning a fixed rate of return on the bond" but "paying a floating rate" on a related obligation. (*Id.*) Twenty-First Securities' marketing materials explained, however, that simply purchasing a fixed-rate security with a variable-rate loan would have less-than-optimal tax consequences, because "[n]ormally, when a taxpayer purchases a zero coupon bond, the taxpayer must accrue and recognize interest income on an annual basis for tax purposes, even though no cash is received until the bond matures or is sold." (*Id.*) *See* I.R.C. § 1272 (original issue discount rules). That annual investment income would be "taxed at the highest marginal tax rate." (*Id.*)

To "convert investment income taxed at the highest marginal tax rate into long-term capital gains" that "are taxed at a more favorable rate," Twenty-First Securities "suggest[ed] the purchase of a zero coupon bond — typically a Treasury or other AAA rated security — having a maturity of more than one year that is leveraged through a 'bond loan'." (SER 15.) As Twenty-First described it, the tax benefits of this arrangement would flow from the fact that "when a taxpayer loans a security to a borrower . . . and certain criteria are met, then the taxpayer lending the security will no longer be treated as the owner of

the security for federal tax purposes." (*Id.*) Accordingly, the marketing write-up reasoned, because the bond was on loan, the taxpayer would not have to recognize interest income on an annual basis, but would retain his basis in the bond, with the result that income that normally would be taxed as ordinary income would instead be taxed as long-term capital gains:

> Since the taxpayer is no longer the holder of the bond, during the period the bond is loaned, the taxpayer should not have to include in its taxable income the accretion of the discount attributable to that period. Furthermore, when the bond is returned, the taxpayer's basis in the bond is the same as it was on the date it was loaned.
>
> Therefore, when the taxpayer sells the bond, a capital gain should be recognized that will approximate the amount of income that would have been recognized during the period in which the bond had been loaned. The gain will be treated as a long-term capital gain as long as the transaction is held open for more than one year. The leveraging of the purchase creates interest expense deductible against a taxpayer's investment income.

(*Id.*) The marketing write-up concluded that "if structured properly, the transaction potentially will result in a pre-tax profit, while generating income taxed at favorable rates and expenses deducted at the highest rate." (*Id.*)

C. The transaction (as executed)

1. The October 2001 transfers

The Samuelis entered into a transaction similar to the ones described in the Twenty-First Securities marketing write-up and in the Ricks memorandum. In October 2001, the Samuelis purchased from Refco, a brokerage company, a principal strip of an unsecured obligation issued by Freddie Mac (more formally, the Federal Home Loan Mortgage Corporation) ("the securities") with a maturity date of February 15, 2003. (ER 67, 69, 78.) The par value of the securities was $1.7 billion. (ER 69, 70.) The Samuelis purchased the securities for $1,643,322,000 ($1.64 billion), or 96.666 percent of par value. (ER 69.) As Ricks had explained in his memorandum, once the Samuelis purchased the securities, the rate of return on the securities was fixed at "the rate at which the purchase price is discounted from the strip's par value due at maturity." (SER 4.)

The Samuelis funded the purchase with a margin loan from Refco, secured by the securities and by $21.25 million they deposited with Refco. (ER 69-70.) The trade was placed on October 17, 2001, and settled on October 19, 2001. (ER 69.) Upon settlement, the Samuelis immediately transferred the securities back to Refco, and Refco

simultaneously provided to the Samuelis $1,643,322,000 ($1.64 billion) in cash. (ER 71.) It is stipulated that the Samuelis "used the $1,643,322,000 cash collateral to pay off the margin loan used to purchase the Securities." (ER 71.)

2. The governing agreements

The transfer of the securities to Refco and the corresponding transfer of cash to the Samuelis were governed by a Master Securities Loan Agreement (the Agreement) and an Amendment to the Master Securities Loan Agreement (the Amendment), both dated October 11, 2001, and an Addendum to the Master Securities Loan Agreement (the Addendum) that was dated October 17, 2001. (ER 68, 69, 71.) The Agreement and the Amendment were both on standard forms published by the Bond Market Association. (ER 68.) The Addendum was not on a standard form. (*See* ER 111.)

Pursuant to the Agreement, when the Samuelis transferred the securities to Refco, they obtained the right to receive identical securities from Refco in the future. (ER 71.) In addition, pursuant to the Agreement and the Amendment, they became obligated to pay Refco a fee ("the collateral fee") for the use of the $1.64 billion they had received from Refco (and then used to pay off the margin loan). (ER

72.) The collateral fee was variable: it was set equal to the one month London Inter Bank Offered Rate ("LIBOR") plus ten basis points, and reset on the first Monday of each month.[4] (ER 72.) (The Samuelis' $21.25 million deposit accrued interest, in the Samuelis favor, at the same rate. (ER 72.)) As of October 17, 2001, trade date, the yield to maturity on the securities was 2.5810 percent. (ER 72.) Accordingly, the Samuelis stood to profit from the transaction to the extent that the LIBOR plus ten basis points fell below 2.5810 percent (*i.e.*, to the extent the LIBOR fell below 2.4810 percent). (ER 72.)

The standard agreement provided that Refco (*i.e.*, the borrower of the securities) was obligated to "daily mark to market any Loan hereunder," and transfer additional collateral to the Samuelis (*i.e.*, the lender of the securities) as necessary to ensure that the value of the collateral remained equal to 100 percent of the market value of the securities. (ER 73.) The Samuelis were entitled to demand additional collateral under similar circumstances. (*Id.*)

The standard form used for the Agreement also provided that the Samuelis could terminate the transaction at any time. (ER 89.) In

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[4] From the opening of the transaction (October 19, 2001) until the first Monday in November 2001, the fee was 2.60125 percent. (ER 72.)

particular, it provided that the Samuelis could "terminate a Loan on a termination date established by notice given to [Refco] prior to the close of business on a Business Day," where

> [t]he termination date . . . shall be a date no earlier than the standard settlement date for trades of the Loaned Securities entered into on the date of such notice, which date shall, unless Borrower and Lender agree to the contrary, be . . . (ii) in the case of all other securities, the third Business Day following such notice.

(ER 89.) The parties' customized Addendum, however, provided that the transaction "shall terminate on January 15, 2003; provided, however, that at [the Samuelis'] option, the Specified Loan may be terminated on July 1, 2002 or December 2, 2002."[5] (ER 74.) January 15, 2003, was one month before the maturity date of the securities. (ER 78.) To terminate early, the Samuelis were required to "advise Refco . . . no later than the reset date . . . immediately preceding the termination date" (ER 111) — *i.e.*, by the first Monday of June 2002, or the first Monday of November 2002. It was stipulated by the parties in

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[5] Had the Samuelis elected to terminate the transaction on either of these dates, Refco would have had the right to purchase the securities at a price produced by a formula contained in the Addendum. (ER 75.) On both July 1 and December 2, 2002, that price was greater than the trading price of the securities, and also greater than the price listed in Refco's brokerage statements. (ER 80.)

the Tax Court that "[b]y limiting its ability to exit the transaction at any time, Shiloh increased its risk of loss." (ER 74.)

3. The interim cash transfers

During December 2001, Ricks communicated with Szem (of Arthur Anderson), Boczar (of Twenty-First Securities), and other planners involved in the transaction regarding the size of the interest deduction the Samuelis could take for 2001.[6] (ER 81.) Ricks's initial email indicates that "[t]echnically, there are two liabilities: the loan and the collateral held by Shiloh. When we pay interest on the loan we are also paying Refco a collateral fee. How this all gets reflected on the books is not clear to me." (SER 9.) Ultimately, Boczar concluded that "[t]he trade generated $7,815,983.33 of interest expense in 2001." (ER 81.) He arranged for the Samuelis to pay this $7.8 million to Refco via a wire transfer in the last week of December 2001, and assured Ricks that "[a]bout two weeks from the date the wire is initiated, the money can be returned." (ER 81.)

On December 28, 2001, consistent with the Boczar memorandum, the Samuelis wired the $7.8 million to Refco. (ER 82.) Refco accounted

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[6] Ricks himself also took an interest deduction for 2001, on account of his 0.2 percent interest in the transaction. (ER 60.)

for this transfer by reducing the amount the Samuelis owed it. (*Id.*) Just over two weeks later, on January 14, 2002, Refco transferred the same $7.8 million back to the Samuelis. (*Id.*) Refco accounted for this transfer by increasing the amount of cash collateral in the Samuelis' account. (*Id.*) The Samuelis deducted the $7.8 million as an interest expense on their 2001 tax return. (ER 45.)

In April 2002, Szem sent to Michael Shulman, the managing director of H&S Ventures, a letter regarding IRS Announcement 2002-2, announcing that penalties would be waived if certain transactions were disclosed to the IRS in a timely fashion. (ER 65, 84.) Pursuant to that announcement, the Samuelis attached to their 2001 tax return a form disclosing the transaction here at issue. (*Id.*)

In December 2002, Boczar again informed Ricks that a similar wire-back arrangement could be entered to create an interest deduction for the Samuelis' 2002 tax year in the amount of $32,009,665. (ER 82.) The Samuelis did not, however, wire any money to Refco at the end of 2002 (*id.*), and accordingly did not take any interest expense deduction related to this transaction for their 2002 tax year.

4. The January 2003 transfers

The Samuelis did not exercise their contractual right to terminate the transaction on either July 1 or December 2, 2002. (ER 75.) Accordingly, consistent with the terms of the Addendum, the transaction terminated on January 15, 2003. (ER 83.)

As of January 15, 2003, the Samuelis owed Refco $1,684,185,567 ($1.68 billion), *i.e.*, return of the $1.64 billion "cash collateral" plus the accrued variable-rate cash collateral fees. (ER 83.) On January 15, 2003, Refco purchased the securities from the Samuelis for $1,697,795,219 ($1.69 billion), *i.e.*, the market value of the securities on that date. (ER 18, 83; SER 10.) On January 16, 2003, the Samuelis received a $35,388,983 wire transfer from Refco. (ER 19.) That $35.3 million comprised a return of their $21.25 million deposit, accrued interest of $529,331 on the deposit, and $13.6 million in economic gain (*i.e.*, the $1.69 billion purchase price minus the $1.68 billion in cash-collateral fees and other relatively minor expenses). (*Id.*) On their 2003 income tax return, the Samuelis reported $50 million of long-term capital gain (*i.e.*, $1.69 billion minus the 2001 purchase price of $1.64 billion). (ER 20, 83.) They also claimed $32,792,720 ($32.7 million) in interest expense deductions for 2003. (ER 20.)

D. The IRS's deficiency determination

The Commissioner examined the Samuelis' 2001 and 2003 returns and concluded that the securities "loan" did not qualify for nonrecognition treatment under I.R.C. § 1058, and that taxpayers were not entitled to their claimed interest deductions. As a result, the Commissioner determined that, in 2003, the Samuelis had $13.6 million in ordinary income instead of the $50 million of long-term capital gains that they had reported. (ER 45.) The Commissioner also disallowed their $7.8 million interest deduction for 2001 and the $32.7 million interest deduction for 2003. (*Id.*) As a consequence, the Commissioner determined a $2.1 million deficiency for the Samuelis' 2001 tax year and a $171,026 deficiency for their 2003 tax year. (ER 37.)[7]

E. The Tax Court proceedings

The Samuelis and the Rickses each filed petitions in the Tax Court and those petitions were consolidated by the court. The taxpayers moved for summary judgment, contending that the reporting

[7] The Commissioner also determined a $6,126 deficiency for the Ricks's 2001 tax year, based on the disallowance of their claimed interest deduction. (ER 55.)

of the transactions in question was correct pursuant to I.R.C. § 1058. The IRS filed a cross-motion for summary judgment, asserting that the agreements underlying the transactions did not satisfy the requirements of § 1058 in that they reduced the taxpayers' opportunity for gain. *See* I.R.C. § 1058(b)(3).

The Tax Court denied taxpayers' motion and granted the Commissioner's cross-motion, holding that the "loan" of the securities from the Samuelis to Refco did not qualify as a securities lending arrangement under I.R.C. § 1058. (ER 10.) As a consequence, the court held, taxpayers could not take their claimed interest deductions in 2001 "because the debt that [taxpayers] claimed was related to the Transaction did not exist." (*Id.*)

The "primary issue," the Tax Court explained, was whether the agreements governing the transactions met the requirement of I.R.C. § 1058(b)(3). (ER 22.) That section provides that, for a securities loan to qualify for nonrecognition treatment, the agreements governing the purported loan must "not reduce the . . . opportunity for gain of the transferor of the securities in the securities transferred." I.R.C. § 1058(b)(3). Relying on the ordinary meanings of "reduce" and "opportunity," the court explained that the instant agreement would

not meet that requirement "if during the transaction period [the Samuelis'] ability to realize a gain in the Securities was less with the Agreement than it would have been without the Agreement." (ER 23.) The governing agreements at issue here failed this test, the court concluded, because by preventing the Samuelis from selling the Securities "on all but three days of the approximate 450-day transaction period" (*id.*), "the Agreement limited [the Samuelis'] ability to sell the Securities at any time that the possibility for a profitable sale arose" (ER 24).

The Tax Court rejected taxpayers' argument that all the requirements of § 1058 were met, because they retained *some* opportunity for gain simply by retaining the securities through the end of the transaction period. (ER 24.) "The statute does not speak to retaining the opportunity for gain," the court explained, "[i]t speaks to whether the opportunity for gain was reduced." (*Id.*) As the court pointed out, "[a] taxpayer has . . . an opportunity for gain as to a security only if the taxpayer is able to effect a sale of the security in the ordinary course of the relevant market . . . whenever the security is in-the-money." (ER 25.) Accordingly, the court held, any "significant

impediment to the taxpayer's ability to effect such a sale . . . is a reduction in a taxpayer's opportunity for gain." (*Id.*)

The court rejected, as besides the point, the taxpayers' argument that the Samuelis retained the opportunity for gain on the transaction as a whole, *i.e.*, "on whether their fixed return on the Securities was greater than their [variable rate] financing expense." (ER 25.) The statute, the court pointed out, "speaks solely to the transferor's 'opportunity for gain . . . in the securities transferred' and does not implicate the consideration of any independent gain that the transferor may realize outside of those securities." (*Id.*, quoting I.R.C. § 1058(b)(3).) And, even if the profitability of the transaction as a whole depended on the variable rate financing fee, the court explained, "the Samuelis' opportunity for gain in the transferred securities rested on the fluctuation in the value of the Securities." (ER 26.) Similarly, the court concluded that a hypothetical financial transaction by which the Samuelis could have locked in the gain in the Securities on any given day had "no direct bearing on our inquiry" because the statute "concerns itself only with the agreement connected with the transfer of the securities." (*Id.*)

The Tax Court also rejected the taxpayers' argument that its reading of I.R.C. § 1058(b)(3) rendered redundant a related Code section, § 512(a)(5)(B). (ER 27.) Section 512(a)(5)(B) expressly requires that (in order to qualify for certain, favorable tax treatment) a securities loan be terminable on five days notice. That requirement, the Tax Court stated, is distinct from the requirement in § 1058(b)(3), "that the lender be able to demand a prompt return of the loaned securities." (ER 28.) The court further pointed out that its interpretation was consistent with the plain language of the statute and its legislative history. (*Id.*) Indeed, the court observed, the "legislative history explains that section 1058 codified the firmly established law requiring that a securities loan agreement keep the lender in the same economic position that the lender would have been in had the lender not entered into the agreement." (ER 30.) And that established law indicated that it had long been viewed as a definitive feature of securities loans that "both parties to the loan agreement could terminate the agreement on demand and thus cause a return of the stock to the lender." (ER 31, citing *Provost v. United States*, 269 U.S. 443, 452-453 (1926).)

Accordingly, the Tax Court concluded, "the underlying transfers of the Securities in 2001 and 2003 were therefore taxable events." (ER 32.) That is, instead of purchasing the securities in 2001 for $1.64 billion and selling them in 2003 for $1.69 billion, as they had reported, the Samuelis should properly be treated as (i) purchasing the securities in 2001 for $1.64 billion and then selling again on the same day for the $1.64 billion in cash that Refco transferred to them, and (ii) repurchasing the securities in 2003 for the $1.68 billion in "cash collateral fees" transferred at the same time and then immediately reselling them to Refco for $1.69 billion. (*Id.*) The Tax Court thus determined that "the economic reality" of the arrangement was "not a securities lending arrangement as structured but was in substance two separate sales of the Securities without any resulting debt obligation running between [taxpayers] and Refco from October 2001 through January 15, 2003." (*Id.*) There was no tax liability for 2001, because there was no gain on the sale-and-resale of the securities in October 2001. (ER 33.) The tax liability for 2003 was based on the difference between the purchase and sale prices, and "is taxed as a short-term capital gain because the Samuelis held the Securities for less than a year." (*Id.*) In this regard, the Tax Court rejected taxpayers' argument

that they actually had a long-term capital gain based on the surrender of the contractual right, purchased in 2001, to receive the securities in January, 2003. (ER 33-34 n.14.) The court pointed out that "the Samuelis transferred the $1.64 billion to Refco in 2001 to purchase the Securities" and "the Securities were the subject of the sale in 2003, not the surrender of a contractual right." (ER 34 n.14.)

The Tax Court then turned to the "secondary issue" whether taxpayers were entitled to their claimed interest deductions. (ER 34.) The court disagreed with taxpayers' position that their purported interest payments were "made with respect to debt in the form of cash collateral." (*Id.*) To the contrary, the court concluded that the "claimed interest payments for 2001 and 2003 . . . were unrelated to debt." (*Id.*) The cash transferred in 2001, the court explained, "represented the proceeds of the first sale and not collateral for a securities loan. Thus, no 'cash collateral' was outstanding during the relevant years on which the claimed collateral fees could accrue.'" The cash transferred by the Samuelis in 2003, the court explained, "was to purchase the Securities pursuant to the forward contract." (ER 34-35.)

In a separate opinion, the Tax Court later dismissed for lack of jurisdiction certain issues raised by the Samuelis. (ER 122; *see Samueli v. Commissioner*, 132 T.C. No. 16 (2009).)[8]

The Tax Court entered decisions in each case consistent with its opinions. Taxpayers now appeal.

[8] The Samuelis do not challenge on appeal this aspect of the Tax Court's decision.

SUMMARY OF ARGUMENT

The Tax Court correctly held that taxpayers' purported securities loan transaction did not qualify for nonrecognition of gain treatment under I.R.C. § 1058. The court also correctly held that the interest deductions claimed by taxpayers on their returns for the years 2001 and 2003 were invalid because, in substance, there never was any outstanding indebtedness running from taxpayers to their purported creditor, Refco.

1. No gain or loss is recognized on a securities loan transaction that satisfies all the requirements of I.R.C. § 1058. In order to come within the ambit of that provision, the agreement governing the parties' securities, among other things, must not reduce the lender's opportunity for gain in the transferred securities. It is customary in securities loan transactions for the lender to be able to recover the securities upon his providing the borrower with a short period of advance notice (typically three to five days). In the instant case, however, the parties agreement severely limited taxpayers' ability to terminate the agreement and obtain the return of their securities prior to the expiration of the agreement, which was 450 days after it was executed. As a result, taxpayers were precluded from taking advantage

of favorable fluctuations in the market value of their securities during the lengthy term of the agreement. In these circumstances, the Tax Court was constrained to conclude, as it did, that taxpayers' agreement reduced their opportunity for gain in the securities and that, consequently, taxpayers' purported securities loan transaction did not qualify for nonrecognition of gain treatment under I.R.C. § 1058.

2. Taxpayers claimed large interest deductions for purported fees they paid on cash collateral supposedly advanced to them by Refco. As the Tax Court correctly held, however, the undisputed facts demonstrated that, in substance, there was no outstanding cash collateral that would support the interest deductions claimed by taxpayers. The record shows that in the year 2001 taxpayers engaged in a series of largely offsetting steps the net substance of which was a purchase from Refco of $1.64 billion of securities followed by an immediate resale of those securities for the same price. Thus, the $1.64 billion that taxpayers received from Refco represented the purchase price of the securities that Refco purchased from them, not cash collateral advanced to them by Refco. Similarly, the cash transfers that occurred in the year 2003 were made pursuant to a forward contract for the sale of securities, and gave rise to no indebtedness. Thus, as was

the case with respect to their claimed interest deductions for 2001, taxpayers' 2003 interest deductions were also invalid as a matter of law.

The decisions of the Tax Court should be affirmed.

ARGUMENT

The Tax Court correctly concluded that taxpayers were not entitled to nonrecognition treatment on the transactions, and were not entitled to interest deductions in 2001 and 2003

Standard of review

This Court reviews the Tax Court's grant of summary judgment *de novo*. *Kadillak v. Commissioner*, 534 F.3d 1197, 1200 (9th Cir. 2008); *Miller v. Commissioner*, 310 F.3d 640, 642 (9th Cir. 2002); *Gladden v. Commissioner*, 262 F.3d 851, 853 (9th Cir. 2001).

A. Introduction: securities loans and the tax treatment thereof

There has long existed, in the "stockbrokerage business," a transaction "commonly known . . . as the 'loan' of shares of stock and the return by the borrower to the lender of shares of stock 'borrowed.'" *Provost v. United States*, 269 U.S. 443, 449 (1926).[9] In these securities "loans," the lender conveys the securities to the borrower, who in turn "deposits with the lend[er] the[] full market price" of the securities. *Id.* at 451. That deposit is adjusted daily "until the loan is returned . . . by means of daily payments back and forth between the borrower and the

[9] Such "loans" are "usually, though not necessarily, incidental to a 'short sale,'" as explained in *Provost*, 269 U.S. at 450.

lender, at the varying level of the market value of the shares loaned." *Id.* at 451-452. The lender, in turn, "usually pays interest on the money so received." *Id.* at 452. Both the borrower and the lender may terminate the transaction "on demand," *i.e.*, the borrower must "return the stock borrowed on repayment to him of his cash deposit . . . with interest as agreed." *Id.* Finally, the lender and borrower are obligated by contract to mimic the benefits and burdens of ownership in the securities (including the distribution of dividends), so that economically it is "as though the lender had retained the [securities]." *Id.* at 452.

The appropriate taxation of the transfer of securities pursuant to such "loans" long has posed something of a problem. On the one hand, title to the securities is transferred from the lender to the borrower (and, upon return, transferred back to the borrower); but, on the other hand, the lender remains in almost the same economic position as if he had never transferred that title, and typically will regain title at the end of the loan. In the *Provost* case, *supra*, the Supreme Court held that, because dominion over the securities changed hands as part of this "loan," both the "loan" and the "return" of the securities were

"taxable transfers" subject to a stamp tax on transfers of securities.[10] *Id.* at 450, 459. The Court distinguished the "loan" of securities, accompanied by cash collateral, from a loan of cash for which the *security* is pledged as collateral — a transaction not subject to the stamp tax at issue in *Provost* — on the same grounds. Unlike the lender of cash who accepts securities as collateral, the borrower of the securities is "neither a pledgee, trustee nor bailee for the lender," the Court explained, because he has no obligation to "have specific stock available for the pledgor on payment of his loan." *Id.* at 456. And the lender is *not* truly in the same position as if he had retained the securities, the Court explained, because "[f]or the incidents of ownership, the lender has substituted the personal obligation, wholly contractual, of the borrower to restore him, on demand, to the economic position in which he would have been, as owner of the stock, had the loan transaction not been entered into." *Id.*

The stamp tax at issue in *Provost* was repealed long ago. But the character of the transfers designated the "loan" and the "return" of securities in the type of securities "loan" at issue there remains

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[10] Taxpayers' assertion (Br. 33) that the Court in *Provost* held that the transfers there at issue were *not* taxable is simply wrong.

relevant for federal tax purposes. As a general rule, all "realized" gains, *i.e.*, accessions to wealth resulting from a sale or exchange, are "recognized" for federal income tax purposes, that is, are subject to current taxation. I.R.C. § 1001(c); Treas. Reg. § 1.61-6(a). *See Teruya Bros., Ltd. v. Commissioner*, 580 F.3d 1038, 1042 (2009). By statute, however, realized gains or losses from certain transactions may go unrecognized. Such exchanges are commonly referred to as nonrecognition transactions. For example, I.R.C. § 1031 provides that no gain or loss is recognized on the exchange of properties of like kind held solely for productive use in a trade or business or for investment purposes. As this Court recently has explained, "[t]he concept behind this exception derives from the assumption that when an investor exchanges a piece of property for another of like-kind, he is merely continuing an ongoing investment, rather than ridding himself of one investment to obtain another." *Teruya Bros.*, 580 F.3d at 1042. A similar rationale might be said to apply to securities loans, where the lender has exchanged the security itself for a contractual right that puts him in virtually the same economic position, together with the expectation that he will eventually regain the security itself. Accordingly, despite the repeal of the old stamp tax, the analysis in

Provost remains relevant to the issue whether the "loan" and "return" of securities pursuant to a securities loan are recognition events for income tax purposes.[11]

Despite the Supreme Court's conclusion, in *Provost*, that the "loan" and "return" of securities were taxable transfers under the old stamp tax, in 1948 the IRS informed the New York Stock Exchange in a Private Letter Ruling (PLR) that the "loan" and "return" of securities pursuant to a securities loan terminable on demand would not be treated as a disposition of property for income tax purposes so that the lender would not recognize gain (or loss) on the transfer of legal title in the securities to the borrower pursuant to the "loan," nor would the borrower recognize gain (or loss) on the retransfer of legal title pursuant to the "return" of the securities. *See* S.Rep. 95-762 at 4 (1978)

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[11] Nonrecognition status carries a "toll charge"; in return for current non-taxability, the basis of the new property takes on the basis of the old, or is reduced by nonrecognized gain, so that ultimate taxability on the nonrecognized portion will be assured on the disposition of the new property. These statutes are therefore more accurately viewed as tax-deferral statutes, rather than tax-exemption statutes. Tax deferral benefits the taxpayer because of the time-value of money, and also because gain on the disposition of property held for more than one year is taxed at more favorable long-term capital gains rates, whereas gain on property held for shorter periods is taxed as ordinary income.

(quoting the 1948 PLR).[12] Similarly, the IRS concluded in a 1957 Revenue Ruling that the delivery of securities by an optionee to a broker pursuant to a contract calling for return of identical securities at a later date was not a taxable disposition, provided that the broker actually returned identical securities. Rev. Rul. 57-451, 1957-2 C.B. 295. But in 1960, the IRS ruled (on the basis of the Supreme Court's reasoning in *Provost*) that because the lender no longer holds title to the security, for tax purposes payments he receives from the borrower in lieu of dividends are *not* treated as dividends. Rev. Rul. 60-177, 1960-1 C.B. 9. In 1972, a further administrative ruling called into question the breadth of the 1957 revenue ruling's applicability. *See* IRS GCM 34967, 1972 WL 32250 (July 31, 1972).

By 1978, Congress had become concerned that uncertainty regarding the tax treatment of securities loans for lenders was impeding the ability of brokers to borrow securities and thus limiting the number of short sales. S.Rep. 95-762 at 5. Accordingly, to clarify the law, Congress enacted I.R.C. § 1058. *See id.* at 7. That section

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[12] The PLR had been published by both major tax services. *See* 5 CCH 1948 Stand. Fed. Tax Rep. ¶6136; 6 P-H 1948 Fed. Taxes ¶ 76,270. *But see* I.R.C. § 6110(k)(3) (PLRs may not be used or cited as precedent).

provides nonrecognition treatment for both the "loan" and the "return" of securities pursuant to a securities loan, provided that the governing agreements (i) provide for the return of securities identical to the securities transferred (I.R.C. § 1058(b)(1)); (ii) require the borrower to place the lender in the same economic position as if he had retained legal title to the securities throughout the period (I.R.C. § 1058(b)(2)); and (iii) "not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred" (I.R.C. § 1058(b)(3)).[13]

"Exceptions to the general rule requiring the recognition of all gains and losses on property dispositions are to be 'strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception.'" *Teruya Bros.*, 580 F.3d at 1043 (quoting Treas. Reg. § 1.1002-1(b)). "Thus, '[n]onrecognition is accorded by the Code only if the exchange is one which satisfies . . . the specific description in the Code of an excepted exchange.'" *Id.* Taxpayers here argue that their transfer of the securities to Refco in

[13] The statute also requires that the transaction meet "other requirements" prescribed by regulation, I.R.C. § 1058(b)(4), but no final regulations have been issued.

October 2001, and Refco's return of the securities to them in January 2003, are entitled to nonrecognition treatment pursuant to I.R.C. § 1058. As we shall demonstrate, however, the transactions at issue here failed to meet the requirement of I.R.C. § 1058(b)(3) that the agreements "not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred." As a consequence, the transactions did not qualify for nonrecognition treatment, and thus should be taxed as if the taxpayers had acquired and disposed of the securities twice, once in October 2001 and then again in January 2003.

B. Taxpayers' transactions did not qualify for nonrecognition treatment under I.R.C. § 1058

1. The terms of the governing agreement reduced taxpayers' opportunity for gain in the securities

As the Supreme Court explained in *Provost*, it has always been characteristic of securities loans that they are "terminable on demand." *Provost*, 269 U.S. at 452. In practice, "on demand" means that demand may be made on any business day, after which the securities must be returned within a customary period. At the time § 1058 was enacted, for example, the Senate Finance Committed noted that SEC rules

required "that the lender be able to terminate the loan with 5 business days notice." S.Rep. 95-762 at 6. The form securities loan agreement published by the Bond Market Association, and used by taxpayers and Refco as part of the agreement governing the transaction, provided for return of the securities on three days notice, with notice to be given on any business day. (ER 89.) Similarly, I.R.C. § 512(a)(5)(b)(ii), which deals with "transaction[s] to which section 1058 applies" applies only if the agreement provides for "termination of the loan by the transferor upon notice of not more than 5 business days."

The lender's ability to terminate a securities loan at any time and to receive the lent securities within a short period, combined with the practice of adjusting the cash collateral on a daily basis, is necessary to ensure that the lender remains in the same economic position under the loan agreement as before he entered it. To be sure, the borrower has a separate contractual obligation to make payments equal to the dividends and other distributions that the lender otherwise would have received on account of the security. But dividends and distributions are only one way an investor can profit from a security. Investors also may profit by opportunely trading securities depending on the market price. The ability to terminate a securities loan on short notice is essential to

the lender's continued ability to sell his security when the market is up, and thus is essential to maintaining the lender in the same economic position (for practical purposes) as when he held the security. *See* S. Rep. 95-762 at 7 (noting that the reason for the conditions of I.R.C. § 1058(b) is "to assure that the contractual obligation does not differ materially either in kind or in extent from the securities exchanged").

The agreements governing the transactions at issue here failed to provide this mechanism for keeping the lender in the same economic position they were in before lending the securities. Rather than adopting the three-day notice period of the Bond Market Association form or the five-day notice period of the SEC rules and I.R.C. § 512(a)(5), taxpayers and Refco specified in the Addendum that the purported securities loan was terminable only on the first Monday of July 2002 or the first Monday of December 2002, and that, in either case, notice must be given by the first Monday of the preceding month (*i.e.*, June 2002 or November 2002). (ER 74, 111.)

These alterations from the customary notice and termination terms meant that, by transferring the securities to Refco in October 2001 in exchange for $1.64 billion in cash, taxpayers — unlike lenders in customary securities loans — put themselves in a less advantageous

economic position than they would have been in had they retained the security. The restrictive termination provisions of the Addendum meant that, unlike the lender in a typical securities loan, taxpayers lost the ability to gain from the sale of the security whenever the market value of the security might be up. That taxpayers "would receive back identical securities . . . subject to any and all fluctuations in the market value" (Br. 24) is irrelevant: the point is that unless the lender in a securities loan preserves his ability to realize gain on the securities at any time that the market value moves up — and before it moves down again — then, in the language of the statute, his "opportunity for gain . . . in the securities transferred" has been "reduce[d]." *See* I.R.C. § 1058(b)(3). Accordingly, the terms of the agreements at issue here failed to meet the requirement of I.R.C. § 1058(b)(3), with the result that the two transfers made pursuant to the transaction — the transfer of the securities from taxpayers to Refco in October 2001 in exchange for $1.64 billion, and the transfer of the securities from Refco to taxpayers in January 2003 in exchange for $1.68 billion — did not qualify for nonrecognition treatment.

2. The statutory phrase "opportunity for gain" includes the opportunity for the holder of a security to gain from its sale when the market is up

Taxpayers' assertions that the transaction at issue qualified for nonrecognition treatment under § 1058 is founded on their failure to recognize the well-recognized fact that restrictions on a security holder's ability to sell the security reduce the holder's opportunity for gain — *e.g.*, *Estate of McClatchy v. Commissioner*, 147 F.3d 1089, 1093 (9th Cir. 1998) (applying this principle) — and thus alter his economic position. Taxpayers' arguments about the plain language of the statute and its legislative history are dependent upon the assumption that the statutory requirement that the terms of the loan not reduce the lender's "opportunity for gain . . . in the securities" does not include the lender's ability to promptly recover the securities, so as to be able to sell them when their market value is up. (*See* Br. 23, 29.) As the Tax Court pointed out, however, the ordinary meanings of the words "reduce" and "opportunity" include any diminishment in the chance for the securities holder to profit from his holdings.

Taxpayers' principal argument in support of its anomalous position is its claim that, under the Tax Court's statutory

interpretation, no securities loan would satisfy the requirements of I.R.C. § 1058, because, of necessity, there will always be *some* delay, however momentary, between the time the lender demands return of the securities and the time the borrower returns them. (*See* Br. 35-36.) Congress was well aware, however, at the time that it enacted § 1058 that it was customary in securities lending transactions to impose upon the lender the obligation to provide the borrower with a short period of advance notice (typically three to five days) that he wanted the return of his securities. *See* S.Rep. No. 95-762 at 5-6. That customary period interacts with other securities trading rules and customs to protect the lender against any risk of loss. Present SEC rules, for example, provide a "T+3" settlement period for most securities trades. *See* 17 C.F.R. § 240.15c6-1.[14] Accordingly, a typical securities trader may contract to sell his securities whenever the market is up and demand return of the securities at the same time. If his securities loan uses the customary three-day notice period of the Bond Market Association forms, then he will be entitled to return of the securities in three days — *i.e.*, at the same time that he is required to deliver the securities to the buyer.

[14] The "T+3" rule replaced the SEC's previous "T+5" rule. *See* 59 Fed. Reg. 59137-01, 1994 WL 637524 (Nov. 16, 1994).

In providing in § 1058(b)(3), that nonrecognition treatment is available only, *inter alia*, where the agreement does not reduce the lender's opportunity for gain, Congress obviously did not intend to include any minor reduction that might result from the customary notice requirements. That hardly leads to the conclusion drawn by taxpayers that any restrictions, no matter how severe, on the lender's ability to recover his securities prior to the end of the loan period are to be disregarded in determining whether the agreement reduces the lender's opportunity for gain. In the instant case, as explained above, the agreement governing the purported securities loan precluded taxpayers, except on two specific dates, from recovering their securities during the 450-day period of the loan to take advantage of increases in the market value of the securities.[15] In these circumstances, the Tax Court was constrained to conclude, as it did, that taxpayers' agreement reduced their opportunity for gains in the transferred securities.

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[15] Because the agreement also required taxpayers to provide a month's notice before either of the two specified early termination dates, for all practical purposes taxpayers had no opportunity to take advantage of any favorable fluctuations in the market value of their securities during the 450-day term of their purported securities loan.

Taxpayers' further argument (Br. 37-39) that one who "retains" *some* opportunity for gain, because he ultimately will recover identical securities (or their equivalent), has not had his opportunity for gain "reduced," is plainly meritless. Under the express terms of the statute, to qualify for the nonrecognition of gain treatment provided therein there must not be any *reduction* in the security's holder's opportunity for gain. Thus, it is entirely besides the point that the agreements in issue here did not entirely eliminate taxpayers' opportunity to gain from an increase in the value of the securities over the term of the purported securities loan. The crucial fact remains, and taxpayers have not even attempted to demonstrate otherwise, that their opportunity to gain from an increase in the value of their securities during the term of their purported securities loan was substantially reduced as a result of their severely limited ability to recover the securities from Refco prior to the termination of that agreement.[16] Indeed, if the fact that the lender of the security ultimately will recover

[16] Taxpayers stipulated (ER 74) that "[b]y limiting its ability to exit the transaction at any time, Shiloh increased its risk of loss." This stipulated increase in taxpayers' risk of loss is simply the flip side of the reduction in their opportunity for gain occasioned by their severely limited ability to exit the transaction at any time.

identical securities, together with payments equivalent to any distributions on the securities during the period of the loan, were sufficient to make the transaction qualify for nonrecognition treatment under I.R.C. § 1058, then I.R.C. § 1058(b)(3) would be rendered largely meaningless. The Field Service Advisory (FSA) upon which taxpayers rely (Br. 37-38) does not support their argument that their highly restricted ability to recover their securities did not place "loan" transaction outside the ambit of I.R.C. § 1058.[17] To the contrary, the FSA indicates that the loan at issue there could be terminated by the lender on demand, with a notice period of one business day. *See* FSA 1997 WL 33313772 (Sept. 2, 1997). It concludes that the arrangement preserved the lender's risk of loss and opportunity for gain in the security because when he terminated the loan, the lender would be entitled to the return of securities identical to those lent or, if the borrower could not provide identical securities, to the market value of the securities on the day the borrower should have returned them. *Id.* Thus, the FSA is consistent with the Government's position that, under I.R.C. § 1058, a lending agreement cannot place a lender in a different

[17] FSAs are informal advice to IRS field agents and may not be used or cited as precedent. I.R.C. § 6110(k)(3).

economic position, with respect to the securities, than he would have been had he not loaned the securities. In contrast, the substantial reduction in the opportunity for gain created by the highly restrictive termination terms of the agreements here at issue does render taxpayers' transactions ineligible for nonrecognition treatment under I.R.C. § 1058.

3. The 5-days notice requirement of I.R.C. § 512(a)(5)(B)(ii) does not support taxpayers' interpretation of I.R.C. § 1058(b)(3)

Taxpayers assert (Br. 24-29) that, even if the lender's inability to terminate the loan on short notice distinguishes the transaction here at issue from ordinary securities loans, the Tax Court's interpretation of the statutory requirement that the loan "not reduce the . . . opportunity for gain of the transferor of the securities in the securities transferred," is so overbroad as to render superfluous the notice provisions of a related statute, I.R.C. § 512(a)(5)(B)(ii). That section's specific requirement that securities be returnable to the lender on five days notice, however, is not the same as the more general requirement of I.R.C. § 1058(b)(3) that the terms of the loan not reduce the lender's "risk of loss or opportunity for gain" in the securities.

Section 512(a)(5), enacted in the same legislation as I.R.C. § 1058 (*see* P.L. 95-345 § 2 (1978)), applies only to securities loans where the lender is a charitable institution generally exempt from tax. The overall purpose of I.R.C. § 512(a)(5) is to ensure that charitable institutions not be discouraged from lending securities by concerns about earning unrelated business taxable income. *See* S.Rep. 95-762 at 8. Section 512(a)(5) excludes from unrelated business taxable income "all amounts received in respect of a security . . . transferred by the owner to another person in a transaction to which section 1058 applies" (I.R.C. § 512(a)(5)(A)), but "only with respect to securities transferred pursuant to any agreement . . . which provides for," *inter alia*, "termination of the loan by the transferor upon notice of not more than 5 business days" (I.R.C. § 512(a)(5)(B)(ii)).

The five-day notice period of I.R.C. § 512(a)(5)(B)(ii), which apparently was drawn from the SEC rules that were extant when that statute was enacted, *see* S.Rep. 95-762 at 5-6, is a specific notice period, whereas the rule of I.R.C. § 1058(b)(3), that an agreement not reduce the risk of loss or opportunity for gain, is a far broader requirement that does not necessarily dovetail precisely with the five-day notice period of § 512(a)(5). Indeed, when the IRS proposed regulations

importing the five-days-notice requirement of I.R.C. § 512(a)(5)(B)(ii) into I.R.C. § 1058(b)(3), *see* Prop. Treas. Reg. 1.1058-1(b)(3), 48 Fed. Reg. 33912-01, 33913, 1983-2 C.B. 644, 646 (1983), the American Bar Association complained that such an interpretation of the statute would fail to account for the variation in customary notice periods for securities loans in different national and international markets. ABA, Section on Taxation, Financial Transactions Committee, Subcommittee on Securities Investors and Broker/Dealers, Securities Loans Task Force Report, *published at* 91 Tax Notes Today 107-33 Section IV.2 (1991). It thus would be, for example, reasonable to construe the more general requirement of § 1058(b)(3) as generally forbidding terms providing for five-day notice periods for securities loans in markets where the customary notice period is three days, but as permitting such a notice period for lenders who are charitable organizations entitled to rely on a five-day notice period allowed under § 512(a)(5). In the opposite circumstance, § 1058 may reasonably be read permitting ten-day notice periods where that is customary, but to read § 512 as requiring charitable organizations to abide by the statutory five-day period. In neither circumstance, would a reading of § 1058(b)(3) to require that the "lenders" in securities loans abide by a customary

notice period for termination render § 512(a)(5)(B)(ii) redundant. Accordingly, there is no impermissible repugnancy between § 1058(b)(3) and § 512(a)(5)(B)(ii). "Redundancies across statutes are not unusual events in drafting, and so long as there is no 'positive repugnancy' between two laws, a court must give effect to both." *Connecticut National Bank v. Germain*, 503 U.S. 249, 253 (1992) (internal citation omitted). Similarly, the "most sensible interpretation" of a statute will not be precluded where there is "substantial overlap among the provisions," because "redundancy is not the same as surplusage." *In re BankVest Capital Corp.*, 360 F.3d 291, 301 (1st Cir. 2004).

Indeed, the Supreme Court has rejected the claim that an implicit exception must be read into a statute where necessary to avoid redundancy with a second statute, explaining that "canons of construction are no more than rules of thumb that help courts determine the meaning of legislation." *Connecticut National*, 503 U.S. at 253. The "one, cardinal canon" that courts should turn to "before all others," the Court explained, was "that a legislature says in a statute what it means and means in a statute what it says there." *Id.* at 253-254. "When the words of a statute are unambiguous . . . this first canon is also the last." *Id.* at 254. Under the present circumstances,

therefore, the Tax Court correctly relied on the plain language of § 1058(b)(3) to hold that a purported securities loan agreement that severely limits the lender's ability to recover the securities during the term of the agreement and thereby necessarily reduces the lender's opportunity for gain, is not within the ambit of § 1058.

C. The economic reality of the transaction required denial of taxpayers' claimed interest deductions

1. The purported securities loan properly was recharacterized by the Tax Court as a sale and immediate purchase of securities in 2001 followed by a forward sale of the same securities in 2003

Given the failure of the transaction at issue to qualify for I.R.C. § 1058 nonrecognition treatment, the issue remains whether taxpayers were entitled to the interest deductions they claimed in 2001 and 2003. As the Tax Court correctly concluded, there were no debt upon which interest could have been paid during either 2001 or 2003. Accordingly, for that reason alone, taxpayers were not entitled to their claimed interest deductions. *See* I.R.C. § 163; *Gatto v. Commissioner*, 1 F.3d 826, 828 (9th Cir. 1993) (no interest deduction allowed in the absence of genuine indebtedness).

"[T]ax classifications like 'dividend' and 'return of capital'" — not to mention *debt* and *interest* — "turn on 'the objective economic realities of a transaction rather than . . . the particular form the parties employed." *Boulware v. United States*, 552 U.S. 421, 128 S.Ct. 1168, 1175 (2008) (quoting *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978)). *See also Teruya Bros. v. Commissioner*, 580 F.3d 1038, 1043 (9th Cir. 2009). In particular, the step transaction doctrine — "part of the broader tax concept that substance should prevail over form," *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1521 (10th Cir. 1991) — holds that a court should refuse to afford tax effect to a "transparently artificial" step taken by a taxpayer so that "[a] given result at the end of a straight path is not made a different result because reached by following a devious path." *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938). "Under this doctrine, the court must view the transaction as a whole even if the taxpayer uses a number of steps to consummate the transaction." *Magneson v. Commissioner*, 753 F.2d 1490, 1497 (9th Cir. 1985). "A taxpayer may not secure, by a series of contrived steps, different tax treatment than if he had carried out the transaction directly." *Id.* The substance of the transaction will control over the form where the taxpayer "could have

achieved the same property dispositions through far simpler means," and "it appears that the[]transactions took their peculiar structure for no purpose except to avoid [the tax consequences]." *Teruya Bros.*, 580 F.3d at 1046. This doctrine does not infringe on the taxpayer's freedom to organize his affairs as he sees fit (*cf.* Br. 44-45) because the question addressed "is not whether alternative routes may have offered better or worse tax consequences . . .; rather, it is 'whether what was done was the thing which the statute . . . intended'" *Boulware*, 128 S.Ct. at 1176 n.7 (quoting *Gregory v. Helvering*, 293 U.S. 465, 469 (1935)). Thus the question here is whether taxpayers' payments constituted "interest" within the meaning of Section 163 of the Internal Revenue Code.

There was no outstanding indebtedness or cash collateral for taxpayers to pay "interest" on here because, as the Tax Court correctly held (ER 32-33), most of the steps taken by taxpayers and Refco in October 2001 that purportedly gave rise to the indebtedness on which they purportedly paid "interest" cancelled each other out. Taxpayers purchased the securities for $1.64 billion, using a $1.64 billion margin loan from Refco secured by a $21.25 million deposit, then immediately transferred the securities to Refco in exchange for $1.64 billion in cash — which they then used to pay off the margin loan. At the same time,

taxpayers acquired the right to transfer to Refco a sum, to be determined by a formula based on the LIBOR, on one of three future dates (the first Monday of July 2002, the first Monday of December 2002, or January 15, 2003), in exchange for which Refco would be obligated to transfer identical securities back to taxpayers. In other words, as the Tax Court concluded (ER 32), the transaction in issue was not a securities lending arrangement, as it purported to be, but, instead was, in substance, two separate sales of the securities (one in 2001 and a second one in 2003) that were effected without any genuine debt obligation running between taxpayers and Refco.[18] As the Tax Court explained, the 2001 transfers were, in economic substance, the Samuelis' purchase and immediate sale of the securities at the same price of $1.64 billion. This purchase and sale gave rise to no indebtedness upon which taxpayers could have made deductible interest payments. On the contrary, the cash transferred in 2001 represented the proceeds from the first sale and not collateral for a securities loan. Thus, as the Tax Court held, "no 'cash collateral' was

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[18] Contrary to taxpayers' protestations (Br. 50), the Tax Court's recharacterization of taxpayers' purported securities loan transaction reflected the same "economic substance" of the transaction identified by taxpayers in their own charts. (Br. 42-43.)

outstanding during the relevant years on which the claimed collateral fees" — treated by taxpayers as deductible interest — "could [have] accrue[d]." (ER 34.)

Similarly, the second securities transaction, which occurred in 2003 — in substance pursuant to a forward contract in securities that was agreed to in 2001 — created no indebtedness on taxpayers' part that would support the deductibility of their purported interest payments in 2003. As the Tax Court held (ER 34), the Samuelis did not transfer any cash in 2003 to Refco in respect of any indebtedness to Refco. On the contrary, "their transfer of cash in 2003 was to purchase the securities pursuant to the forward contract." (ER 34-35.) Accordingly, as the court correctly concluded, taxpayers were not entitled to their claimed interest deductions for 2003 any more than they were entitled to their claimed 2001 deductions.

The Tax Court correctly observed (ER 32-33 n.13) that the transactions in this case are similar to the transactions at issue in the so-called Livingstone cases (named after their creator, Eli Livingstone, a securities dealer), which were designed to create large interest deductions even though no genuine indebtedness existed. The Livingstone transactions utilized a series of essentially offsetting steps

to create the illusion that the taxpayers in question had incurred substantial amounts of indebtedness when, in economic substance, no such indebtedness actually existed. In disallowing the claimed interest deductions, the courts, as did the Tax Court here, did not disregard the entire transactions but, instead, recast them to reflect their actual substance.

For example, in *Lynch v. Commissioner*, 273 F.2d 867, 871-72 (2d Cir. 1959), the court explained that no interest deduction was allowable because "[h]ere no money was used or forborne. When the series of transactions of December 3 to 10 was completed, the parties were exactly where they had been at the outset, save only that each taxpayer had paid $29,114.61 for a contractual right to delivery of the Treasury Notes." *See also Jockmus v. United States*, 335 F.2d 23, 29 (2d Cir. 1964) (following *Lynch* and holding that "[i]n actual effect, what Jockmus obtained was . . . not a loan at all, but merely a contractual right to delivery of the securities in the future upon payment of an agreed price, the amount of the so-called loan"); *Becker v. Commissioner*, 277 F.2d 146, 149 (2d Cir. 1960).

This and other courts reached the same conclusion in the Livingstone cases. The First Circuit held in *Goodstein v.*

Commissioner, 267 F.2d 127, 131 (1st Cir. 1959), that despite the fact that "these transactions did create a legal relationship between the taxpayer and Seaboard," "there was never in substance either a purchase of the notes by the taxpayer or borrowing of the purchase funds from Seaboard," so that the legal relationship between the taxpayer and Seaboard "was not one of borrower and lender. Rather the net result of these transactions was the exchange of promises of future performances between the taxpayer and Seaboard." *Id.* Likewise, in *Cahn v. Commissioner*, 358 F.2d 492, 494 (9th Cir. 1966), *aff'g* 41 T.C. 858 (1964), this Court quoted with approval the Tax Court's conclusions that "[t]he fact that various legal rights and obligations may have been created or that Livingstone may have become liable to petitioner on some contractual basis is beside the point" and "[t]he presence of a risk of gain or loss cannot make a bona fide loan out of one that exists only on paper." *See also MacRae v. Commissioner*, 294 F.2d 56, 60 (9th Cir. 1961), *aff'g* 34 T.C. 20 (1960) (acknowledging "that various legal rights and obligations were created" by "the transactions here," but concluding that they "created no 'indebtedness' recognizable under" the Internal Revenue Code).

Courts also disregarded initial offsetting steps even where the taxpayer suffered an economic loss or made an economic profit. *See Rubin v. United States*, 304 F.2d 766, 770-771 (7th Cir. 1962) ("taxpayer's profit in the instant case is immaterial to the question before us . . . the profit of taxpayer in the instant case does not affect the question whether there was an actual indebtedness between him and Seaboard"); *MacRae,* 294 F.2d at 60 (no indebtedness despite real loss); *Becker*, 277 F.2d at 149 (no indebtedness despite real loss).

In sum, the Tax Court correctly held that the undisputed facts established that, in substance, there was no actual indebtedness running from taxpayers to Refco during the years in issue and, therefore, correctly concluded that taxpayers' claimed interest deductions were invalid.

2. Taxpayers' arguments are without merit

a. Contrary to taxpayers' assertions, the Tax Court's characterization of the transaction does not "make the transaction more complex" or "invent new steps that never occurred" or "new transactions that never existed." (Br. 56.) Instead, as we have just explained, the Tax Court's characterization of the transaction ignores those steps that cancelled each other out, such as taxpayers' purchase

of the securities from Refco in October 2001 and the immediate retransfer of these securities to Refco in exchange for an equal payment, and accurately describes the economic effects of the remaining steps.

b. Taxpayers' argument that the "interest" paid on the "cash collateral" is necessarily deductible (Br. 48) is besides the point since, as the Tax Court correctly held (ER 34), there was no cash collateral outstanding during the period at issue in this case. Taxpayers' effort to show that the "interest" at issue here was deductible under *Deputy v. DuPont*, 308 U.S. 488, 498 (1940), rests on the erroneous assumption that taxpayers "were required to repay the cash collateral . . . to Refco upon the termination of the loan." (Br. 48.) As we have already explained, however, taxpayers' obligation to Refco constituted an obligation to purchase the securities from Refco at the termination of a forward contract. Taxpayers offer neither argument nor authority for the proposition that a payment made pursuant to a forward contract is a "principal sum" that generates deductible interest.

Nor can taxpayers distinguish the analogous Livingstone line of cases, where the courts held that no interest deduction is allowable where steps taken to create purported debt for tax purposes cancelled

each other out for practical purposes. *See* pp. 52-55, *supra*. Other taxpayers have already attempted to distinguish *Goodstein* on the grounds that their transaction (i) gave them the contractual right to demand delivery of securities; (ii) had "commercial reality since it was entered into for profit and the risk of gain or loss fell upon the taxpayers"; and (iii) was entered in good faith. *Cahn v. Commissioner*, 358 F.2d 492, 493-494 (9th Cir. 1966). This Court rejected the argument, quoting and approving the Tax Court's explanation that "[t]he presence of a risk of gain or loss cannot make bona fide loan out of one that exists only on paper," and concluding that without a bona fide loan there could be no deductible interest payment. *Id.* at 494.

c. Taxpayers' assertion that the $1.69 billion they received in 2003 was actually received in exchange for a "long-term asset," *viz.*, the contractual right to receive the securities, rather than in exchange for the securities themselves (*e.g.*, Br. 57-59), is refuted by the record. It is stipulated that Refco purchased the securities from the Samuelis on January 15, 2003, for $1,697,795,219, *i.e.*, the market value of the securities on that date. (ER 18, 83.) The sales ticket is in the record. (SER 10.) The assertion that Refco paid this amount to terminate the

contract, instead of to purchase the securities from taxpayers, is unsupportable (as the Tax Court found (ER 34 n.14)).

Taxpayers' "long-term asset" argument also rests on the faulty assumption that taxpayers' basis in this "Contractual Right" was $1.64 billion. (Br. 47.) But taxpayers did not pay Refco $1.64 billion for any "Contractual Right"; they paid $1.64 billion for the securities (and then immediately returned them in exchange for return of the $1.64 billion). And taxpayers cannot substitute their basis in the securities for the basis in any contractual right to receive identical securities in the future if, as their argument assumes (Br. 46), "the Taxpayers do not meet any nonrecognition provision." *See* I.R.C. § 1058(c) (providing for substituted basis).

Moreover, there is no merit to taxpayers' suggestion that they may take interest deductions if the $1.69 billion was paid to terminate a "Contractual Right" rather than paid for the securities. Positing a "Contractual Right" as a long-term asset cannot create interest paid on indebtedness where none exists.

d. Finally, the Tax Court's recharacterization of the transaction does not ignore counterparty risks, as taxpayers charge (Br. 53-56). To the contrary, parties to a forward contract bear precisely the same

counterparty risks as taxpayers and Refco bore here. The buyer bears the risk that he will be obligated to perform but the seller will not be able to deliver (*see* Br. 54-55). The seller bears the risk that the buyer will enter bankruptcy and not be able to perform, but that he will still be obligated to deliver the goods to the buyer's bankruptcy estate (*see* Br. 55). Finally, the buyer bears the risk that the goods that are the subject of the contract will decline in value to an amount substantially less than the contracted price (*see id.*).

CONCLUSION

For the foregoing reasons, the decisions of the Tax Court are correct and should be affirmed.[19]

Respectfully submitted,

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[19] The Commissioner argued in the Tax Court that, in the alternative, the transactions here at issue should be taxed pursuant to the recharacterization rules of I.R.C. § 1258, which require recharacterization of certain transactions designed, like this one (*see* SER 13), to transform ordinary income to long-term capital gains. Accordingly, if this Court reverses the Tax Court, the case should be remanded for consideration of the Commissioner's § 1258 argument.

STATEMENT OF RELATED CASES

Pursuant to Local Rule 28-2.6, counsel for the appellee state that this appeal involves the transaction discussed in a "draft" memorandum that this Court held must be produced, pursuant to a summons, in *United States v. Wealth and Tax Advisory Services, Inc.*, 526 F.3d 528 (9th Cir. 2008).

ADDENDUM

Internal Revenue Code of 1986 (26 U.S.C.)

Sec. 512. UNRELATED BUSINESS TAXABLE INCOME.

(a) DEFINITION.—For purposes of this title—

* * *

(5) DEFINITION OF PAYMENTS WITH RESPECT TO SECURITIES LOANS.—

(A) The term "payments with respect to securities loans" includes all amounts received in respect of a security (as defined in section 1236(c)) transferred by the owner to another person in a transaction to which section 1058 applies (whether or not title to the security remains in the name of the lender) including—

(i) amounts in respect of dividends, interest, or other distributions,

(ii) fees computed by reference to the period beginning with the transfer of securities by the owner and ending with the transfer of identical securities back to the transferor by the transferee and the fair market value of the security during such period,

(iii) income from collateral security for such loan, and

(iv) income from the investment of collateral security.

(B) Subparagraph (A) shall apply only with respect to securities transferred pursuant to an agreement between the transferor and the transferee which provides for—

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

(ii) termination of the loan by the transferor upon notice of not more than 5 business days, and

(iii) return to the transferor of securities identical to the transferred securities upon termination of the loan.

* * *

Sec. 1058. TRANSFER OF SECURITIES UNDER CERTAIN AGREEMENTS.

(a) GENERAL RULE.—In the case of a taxpayer who transfers securities (as defined in section 1236(c)) pursuant to an agreement which meets the requirements of subsection (b), no gain or loss shall be recognized on the exchange of such securities by the taxpayer for an obligation under such agreement, or on the exchange of rights under such agreement by that taxpayer for securities identical to the securities transferred by that taxpayer.

(b) AGREEMENT REQUIREMENTS.—In order to meet the requirements of this subsection, an agreement shall—

(1) provide for the return to the transferor of securities identical to the securities transferred;

(2) require that payments shall be made to the transferor of amounts equivalent to all interest, dividends, and other distributions which the owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the transferor and ending with the transfer of identical securities back to the transferor;

(3) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred; and

(4) meet such other requirements as the Secretary may by regulation prescribe.

(c) BASIS.—Property acquired by a taxpayer described in subsection (a), in a transaction described in that subsection, shall have the same basis as the property transferred by that taxpayer.

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(S)__BETHANY B. HAUSER_____

Attorney

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