INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

March 3, 2003

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CASE MIS No.: TAM-152677-02/CC:ITA:B05

Area Director, Field Compliance, SB/SE

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
LLC1 =
LLC2 =
Counsel =
FC =
FCa =
FCb =
$X =
$Y =
$Z =
$U =
Tax Year 1 =
Tax Year 2 =
X percent =
Y percent =

ISSUES:

(1) Whether Taxpayer's claimed loss on the disposition of FC is disallowed on the grounds that Taxpayer improperly determined basis in the FC.

(2) Whether the I.R.C. § 6662 accuracy-related penalty can be asserted against Taxpayer if the loss is disallowed.

CONCLUSIONS:

(1) Taxpayer's claimed loss on the disposition of FC is disallowed because basis in the FC was limited to its fair market value when acquired.

(2) Taxpayer did not have substantial authority for the tax treatment of the loss, and therefore the accuracy-related penalty can be asserted against Taxpayer.

FACTS:

Taxpayer is a member of LLC1. LLC1 purchased some FCa from LLC2. LLC2 had borrowed FCb from a lender group.[1] According to an opinion letter from Counsel, the terms of this loan provided for payment of principal at the end of 30 years, with interest payable annually in arrears. The interest rate was to be reset annually by the lender group. If LLC2 did not accept a reset rate, the debt was to be prepaid.

The Counsel opinion characterizes LLC1's purchase of the FCa as the creation of a "synthetic zero coupon foreign currency debt instrument."[2] The opinion refers to the fact that LLC1 purchased the present value of the FCb due at the end of 30 years (i.e., FCb) and assumed the obligation to pay the full principal amount (i.e., FCa). LLC1 assumed joint and several liability for payment of the loan. In addition, both LLC2 and LLC1 were required to pledge collateral that was required to total the full amount of principal and interest owed to the lender group. LLC1's portion of this collateral was the FC equivalent of approximately $U. Between LLC1 and LLC2, it was agreed that LLC1 would be responsible for payment of principal to the extent principal was not repaid with collateral. LLC2 agreed to make required interest payments.

LLC1 disposed of the FCa.[3] As a result of membership in LLC1, Taxpayer's share of the amount realized on this disposition was approximately $Y. However, Taxpayer's share of the claimed basis in the FCa was approximately $Z, based on the U.S. dollar equivalent of the entire principal amount of the FCb loan. Taxpayer thus reported a loss of approximately $X on his tax return. Approximately one year after the FCb loan was made, it was repaid with collateral that had been pledged by both LLC2

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[1] This memorandum assumes, without having determined, that the loan to LLC2 represented genuine debt and that the sale of FC to LLC1 in fact and in substance occurred.

[2] This transaction is commonly known as known as a Custom Adjustable Rate Debt (CARD) transaction and is similar to transactions recently addressed by the Service in Notice 2002-21, 2002-14 I.R.B. 730.

[3] The exact manner of disposition is not clear. However, the realization event could have been conversion of the FC to U.S. dollars.

and LLC1.

Taxpayer received a legal opinion from Counsel stating that it was "more likely than not" that, for Federal income tax purposes, LLC1 could claim basis equal to the full amount of the assumed debt.

LAW AND ANALYSIS:

Issue 1

Section 1012 of the Internal Revenue Code (Code) provides that the basis of property is equal to the cost of that property. Section 1.1012-1(a) of the Income Tax Regulations defines "cost" to mean the "amount paid" for the property in cash or other property. Under general tax law principles, the amount paid for property generally includes the amount of the seller's liabilities assumed by the buyer. Consolidated Coke Co. v. Commissioner, 70 F.2d 446 (3d Cir. 1934) (basis of purchased plant includes debt assumed by taxpayer); Oxford Paper Co. v. United States, 86 F. Supp. 366 (S.D. N.Y. 1949) (basis of purchased plant includes assumed lease obligation). The inclusion of liabilities in basis by a buyer, however, is predicated on the assumption that the liabilities will be paid in full by the buyer. See Commissioner v. Tufts, 461 U.S. 300, 308 (1983), 1983-1 C.B. 120, 123.

While there can be no argument that the cost basis of property includes the amount of assumed liabilities, it appears equally clear that one dollar of debt should result in no more than one dollar of basis. Accordingly, in the case of joint and several liability and co-ownership of property, an allocation of debt for purposes of basis is necessary to avoid multiple basis.

Thus, Estate of Leavitt v. Commissioner, 90 T.C. 206 (1988), aff'd, 875 F.2d 420 (4th Cir. 1989), illustrates the principle that one dollar of debt should produce no more than one dollar of basis. In that case, the Tax Court refused to give S corporation shareholders additional basis in their stock as the result of guarantees of a loan made to the S corporation. In a concurring opinion, Judge Williams pointed out that if each of the shareholders was allowed to recast the loan as one to the shareholder followed by a capital contribution to the S corporation, each shareholder's basis would be increased by the full amount of the loan, which would result in "multiplication of basis." Id. at 219.

Counsel's opinion cites Hovis v. Commissioner, T.C. Memo. 1995-60, for the proposition that each co-obligor is liable for the full amount of a recourse obligation. However, the case does not foreclose allocating debt for various tax purposes. To the contrary, in that case taxpayers were not permitted to deduct more than their pro rata share of a joint obligation incurred to finance the unsuccessful start-up of a bank.

Although Estate of Leavitt involved a shareholder guarantee of a loan to an S corporation, the principle it expresses, that debt should not produce multiple basis, is

equally applicable in the context of this transaction. Consequently, once it has been determined that basis stemming from the FCb loan in this case must be allocated between LLC2 and LLC1 -- the joint and several obligors – it becomes necessary to determine the method for making the allocation.

In the absence of direct authority, a supportable method of allocating basis looks to the amount of the total debt that each co-obligor can be expected to pay. This approach has been used to determine the portion of a mortgage that a co-obligor can treat as a "cost" of acquiring a replacement residence for purposes of section 1034. For instance, in Snowa v. Commissioner, T.C. Memo. 1995-336, rev'd, 123 F. 3d 190 (4th Cir. 1997), the taxpayer had shared a former residence with one spouse but purchased a replacement residence with another spouse. Section 1034 permitted deferral of gain recognition on the sale of one residence to the extent proceeds were used to purchase a second residence. For this purpose, section 1034(g) allowed a taxpayer to elect to treat as a "cost" of the second residence any consideration supplied by either the taxpayer or her spouse. The Tax Court concluded that this relief provision was not applicable because the old and new residences were shared with different spouses. Because section 1034(g) did not apply, the taxpayer's cost of the new residence included only consideration she supplied, including only her "share" of the mortgage debt incurred to purchase the new residence:

> Petitioner argues, however, that the entire amount of the mortgage should be included in her cost because the lender could require her to pay the full amount of the debt. [Taxpayer's argument in this transaction.] Petitioner fails to recognize that, although the lender could enforce the obligation against one of the joint and several debtors, in such event, the debtor who pays the debt would have the right to seek contribution from the nonpaying debtor. . . .

1995 RIA TC Memo ¶95,336 at 2064-95 (emphasis supplied).

The appellate court reversed the Tax Court and allowed the taxpayer to defer her gain because it found that section 1034(g) did not require that the old and new residences be shared with the same spouse. Thus, the relief provision applied, and the taxpayer could consider as her cost of the second residence all consideration supplied by herself and her new spouse, including the entire amount of the mortgage. Snowa suggests that absent a statutory override, co-obligors who jointly own property must allocate debt used to acquire the property when they determine their respective costs.

Other cases have limited the portion of an assumed indebtedness that may be taken into account for federal income tax purposes. For example, where two or more persons are liable on the same indebtedness, or hold separate properties subject to the same indebtedness, the amount taken into account for federal income tax purposes by each person generally is based on all the facts and circumstances, including the economic realities of the situation and the parties' expectations as to how the liabilities

will be paid. See Maher v. United States, No. 16253-1 (W.D. Mo. 1969) (property was not in substance "subject to" liability where lender was not actually relying on property as collateral); Maher v. Commissioner, 469 F.2d 225 (8th Cir. 1972) (corporation's assumption of primary liability on shareholder's indebtedness becomes taxable dividend only as corporation makes payments as promised).[4]

In this case, LLC1 is responsible for the principal balance of the loan only to the extent that it has not been satisfied from collateral. Thus, the collateral is the primary and expected source of repayment. At the inception of the transaction, LLC2 supplied X percent of the collateral, while LLC1's share of the collateral is some Y percent (FCa).

In addition, in appropriate cases, courts have rejected attempts to assign an inflated basis to property and have limited the basis of property to its fair market value. For example, the basis of property acquired with the issuance or assumption of recourse indebtedness has been limited to the acquired property's fair market value where "a transaction is not conducted at arm's-length by two economically self-interested parties or where a transaction is based upon 'peculiar circumstances' which influence the purchaser to agree to a price in excess of the property's fair market value." Lemmen v. Commissioner, 77 T.C. 1326, 1348 (1981) (citing Bixby v. Commissioner, 58 T.C. 757, 776 (1972)); Webber v. Commissioner, T.C. Memo. 1983-633, aff'd, 790 F.2d 1463 (9th Cir. 1986). See also Majestic Securities Corp. v. Commissioner, 42 B.T.A. 698, 701 (1940), aff'd, 120 F.2d 12 (8th Cir. 1941) ("The general rule that the price paid is the basis for determining gain or loss on future disposition presupposes a normal business transaction.")

The concept of limiting basis from debt to the fair market value of the property acquired also is found in case law concerning nonrecourse debt. The effect of nonrecourse debt on basis was considered by United States Supreme Court in Crane v. Commissioner, 331 U.S. 1 (1947), where the Court held that a taxpayer's basis in inherited property was its fair market value on the date of decedent's death and was not reduced by the amount of nonrecourse debt that encumbered the property. The Court also held that upon disposition of the property, the amount realized included the amount of the debt.

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[4] Debt for which there is joint and several liability has been allocated between co-obligors for other federal income tax purposes, with allocation based on who bears ultimate responsibility for the debt. For instance, among joint and several obligors, interest deductions are available to those debtors that pay the interest. In Mason v. United States, 453 F. Supp. 845 (N.D. Cal. 1978), two co-obligors both made payments on a debt. The court held that the taxpayer making interest payments could deduct the interest. For this purpose, payments by the two co-obligors were considered as being applied first to accrued interest and then to principal, because there was no agreement with the creditor that ordinarily would have required a different allocation.

In Commissioner v. Tufts, 461 U.S. 300 (1983), the taxpayer challenged the second Crane holding, which treated the nonrecourse debt as part of the amount realized upon disposition of the encumbered property. The taxpayer argued that this rule should not apply when the amount of debt exceeds the fair market value of the property. The Court rejected this argument and noted that the taxpayer had included the debt in basis for depreciation purposes and had (based upon a repayment expectation) failed to include the loan proceeds in income upon receipt: "[A] taxpayer must account for the proceeds of obligations he has received tax-free and included in basis." Id. at 313.

Tufts, however, does not foreclose an inquiry into whether the amount of nonrecourse debt so unreasonably exceeds the fair market value of encumbered property that repayment is unlikely. This is explained in Odend'hal v. Commissioner, 748 F.2d 908 (4th Cir. 1984):

> We see nothing in Tufts to alter the well-established rules that a taxpayer may not inflate his depreciation deductions, as did taxpayers here, by including in his basis for depreciation nonrecourse debt when that debt so far exceeds actual value at the time that it is incurred that there is no economic incentive to pay it . . . . In reaching these conclusions, we note that while Tufts did state that "Crane also stands for the broader proposition . . . that a nonrecourse loan should be treated as a true loan," 461 U.S. at 313, it emphasized that Crane was "predicated on the assumption that the mortgage will be repaid in full," id. at 308, and that "the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay." Id. This crucial assumption is lacking in our case. Since the value of the property failed to approach the amount of prior liens and the face amount of the nonrecourse obligations to RCA, taxpayers had no economic incentive to repay the obligations at issue here.

Id. at 913.

In Regents Park Partners v. Commissioner, 1992 RIA TC Memo ¶92,336, the court limited a partnership's basis in property to the property's fair market value. The court noted that one rationale for disregarding the nonrecourse debt in its entirety from basis is the theory that a taxpayer in such circumstances lacks incentive to pay the debt:

> [T]he purported purchaser had no incentive to pay off the nonrecourse note because by abandoning the transaction the taxpayer "can lose no more than a mere chance to acquire an equity in the future should the

> value of the acquired property increase." Estate of Franklin v. Commissioner, supra at 1048.

1992 RIA TC Memo ¶92,336 at 1742-92. The court also cites Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3d Cir. 1988), as authority for a more limited approach that, in lieu of disregarding debt in its entirety, limits basis to the fair market value of the encumbered property. Without resolving the issue of whether excessive nonrecourse debt should be disregarded in its entirety or only in part, the court in Regents Park did find that under the circumstances of that case (the debt was to be renegotiated, bore below-market interest, etc.), a partnership did have an incentive to continue to make payments so that it was appropriate to grant basis, but only to the extent of the encumbered property's fair market value. Id. at 92-1743.

The underlying rationale of these cases, that a taxpayer acquires basis as the result of debt only when the circumstances indicate that the taxpayer will pay the debt, is very relevant to this transaction. The amount that LLC1 was likely to pay is much less than FCb, and its claim to basis premised on payment of this amount is unreasonable.

Based in large part on many of the above authorities, the Service in Notice 2002-21, 2002-14 I.R.B. 730, announced its position with respect to the basis of property acquired by taxpayers in transactions substantially similar to the transaction at issue here. Notice 2002-21 concludes that losses purportedly resulting from such transactions are not allowable to the extent the taxpayer derives a tax benefit that is attributable to a basis in excess of the fair market value of the assets that are the subject of the conveyance. In addition, the Service announced that it may impose penalties, including the accuracy-related penalty under section 6662 of the Code, on participants in such transactions.

In this case, LLC1 assumed joint and several liability for the FCb loan when it acquired FCa from LLC2. Citing this fact, LLC1 claims basis equal to the U.S. dollar equivalent of FCb, the full face amount of the assumed debt. LLC1's basis in the FC, however, should be limited to the fair market value of the FC when acquired, and Taxpayer's claimed loss therefore should be disallowed.

Issue 2

Section 6662(a) of the Code imposes a penalty of 20 percent on a portion of an underpayment of tax required to be shown on the return. The penalty applies to the portion of the underpayment that is attributable to one or more of the following: (1)

negligence or disregard of rules or regulations, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement under chapter 1 [Normal Taxes and Surtaxes], (4) any substantial overstatement of pension liabilities, (5) any substantial estate or gift tax valuation understatement. See I.R.C. § 6662(a), (b).

For purposes of section 6662, the term "underpayment" is defined as the amount by which any tax imposed exceeds the excess of the sum of the amount shown as the tax by the taxpayer on his return, plus amounts not so shown previously assessed (or collected without assessment), over the amount of rebates made. I.R.C. § 6664(a)(1), (2); Treas. Reg. § 1.6664-2(a). An understatement is the excess of the amount of the tax required to be shown on the return for the taxable year, over the amount of tax imposed which is shown on the return, reduced by any rebate. I.R.C. § 6662(d)(2)(A). Generally, there is a substantial understatement of income tax for an individual if the amount of the understatement exceeds the greater of ten percent of the tax required to be shown on the return, or $5,000.00. See I.R.C. § 6662(d)(1)(A).

Section 6662(d)(2)(B) provides that the amount of the understatement is reduced by any portion of the understatement attributable to an item if (1) the tax treatment of any item by the taxpayer is or was supported by substantial authority for such treatment, or (2) the facts relevant to the tax treatment of the item were adequately disclosed in the return or in a statement attached to the return and there is a reasonable basis for the tax treatment of such item by the taxpayer. For a taxpayer other than a corporation, if an item is attributable to a tax shelter, the understatement can only be reduced by an item that is supported by substantial authority and if the taxpayer reasonably believed that the treatment of the item was more likely than not the proper treatment. For purposes of section 6662(d), the term "tax shelter" means: a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax. I.R.C. § 6662(d)(2)(C)(iii).

When determining if an understatement exists, if there is substantial authority for the tax treatment of an item, the item is treated as if it were shown properly on the return for the tax year. Treas. Reg. § 1.6662-4(d)(1). "The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts." Treas. Reg. § 1.6662-4(d)(2). There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. "The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority." Treas. Reg. § 1.6662-4(d)(3)(ii). Types of authority include the following: Internal Revenue Code and other statutory provisions; proposed, temporary and final regulations; revenue rulings and revenue procedures; tax treaties and regulations thereunder; court cases; congressional intent as reflected in

committee reports; General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book); private letter rulings and technical advice memoranda issued after October 31, 1976; actions on decisions and general counsel memoranda issued after March 12, 1981; Internal Revenue Service information or press releases; and notices, announcements and other administrative pronouncements published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-4(d)(3)(iii). In addition, a taxpayer can have substantial authority for a position even if it is supported only by a well-reasoned construction of the applicable statute. Treas. Reg. § 1.6662-4(d)(3)(ii).

In this case, disallowance of the losses from the instant transaction will result in an underpayment. Further, this underpayment is a substantial understatement, because the difference between the amount of tax required to be shown on the Taxpayer's return and the amount of tax which the Taxpayer reported on the return is greater than 10 percent of the tax which the Taxpayer is required to show on the return.

Because this transaction is a tax shelter as defined in section 6662(d), the amount of the understatement is reduced only if Taxpayer satisfies the substantial authority standard and reasonably believed that the tax treatment of this transaction was more likely than not the proper treatment. Regardless of whether Taxpayer can meet the reasonable belief standard, Taxpayer fails to satisfy the substantial authority requirement. While Counsel's opinion concludes that the loss deductions were proper, none of the cases or other authorities cited therein directly, or indirectly, address the type of transaction described in this case. That is, none of the authorities cited by Counsel supports giving the Taxpayer an adjusted basis equal to the U.S. dollar equivalent of FCb in the FCa actually acquired and disposed of by the Taxpayer. In addition, Notice 2002-21 and the authorities cited therein strongly indicate that Taxpayer did not have substantial authority for its reporting position. Consequently, our office concludes that the Taxpayer lacked substantial authority for the position taken. Therefore, the understatement is not reduced, and the accuracy-related penalty can be imposed under section 6662.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.