No. ______

In the
Supreme Court of the United States

KEITH A. TUCKER; LAURA B. TUCKER,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

May the judge-made "economic substance doctrine" be invoked to supplant any tax results that a court deems abusive, even when those results stem from the application of clear, unambiguous, and mechanical provisions of tax law, as the Fifth Circuit held below and other courts of appeals have concluded, or is the doctrine properly invoked only as a tool for interpreting the meaning of tax laws, as the D.C. and Sixth Circuits have held?

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Petitioners Keith A. Tucker and Laura B. Tucker respectfully petition this Court for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. 1a–19a) is unreported, but available at 766 F. App'x 132 (5th Cir. 2019). The Tax Court's opinion (App. 20a–93a) is unofficially reported at 114 T.C.M. (CCH) 326.

JURISDICTION

The court of appeals entered its opinion and judgment on April 3, 2019. App. 1a. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Pertinent statutory and regulatory provisions are reproduced at App. 94a–117a.

STATEMENT OF THE CASE

This case presents a square circuit split about an important, recurring question of federal tax law. Over the last four decades, the lower courts—acting without guidance from this Court—have developed deeply conflicting versions of what is known as the "economic substance doctrine." Some courts, like the D.C. and Sixth Circuits, hold that the doctrine is a "judicial device[] for divining and effectuating congressional intent, not for supplanting it." *Horn v. Commissioner*, 968 F.2d 1229, 1234 (D.C. Cir. 1992). As such, those courts invoke the doctrine to interpret otherwise ambiguous tax rules, but recognize that the doctrine has no application when a rule's text is clear and its application mechanical. Other courts, including the Fifth, Third, and Federal Circuits, invoke the doctrine even where the text clearly and unambiguously authorizes the challenged tax treatment—using the doctrine to *void* the results of such provisions when a court believes that, even though there is no ambiguity in the rule, Congress would not have intended the particular result.

This conflict has great practical importance. Not only does it implicate the proper role (and limits) of courts in giving effect to unambiguous provisions of law, but it impacts the ability of taxpayers to rely on the law as written. As Judge Sutton observed in a similar vein, "[i]f the government can undo transactions that the terms of the Code expressly authorize, it's fair to ask what the point of making these terms accessible to the taxpayer and binding on the tax collector is." *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779, 782 (6th Cir. 2017). Likewise, he continued, "[t]he best way to effectuate Congress's nuanced policy judgments is to apply each provision as its text requires—not to elevate purpose over text when taxpayers structure their transactions in unanticipated tax-reducing ways." *Id.* at 788–89.

In this case, Petitioner Keith Tucker[1] made a bona fide investment that had a 40 percent chance of generating a significant profit. Through a mechanical application of three unambiguous tax rules—a bright-line, 30-day rule that excluded certain foreign income from taxation and two rules that allowed taxpayers to make elections between available tax treatments—

[1] Keith and Laura Tucker filed a joint tax return for the tax year at issue. As a result, Mrs. Tucker is also a petitioner here. Since the events at issue primarily concern Mr. Tucker, this petition generally refers to him throughout.

the investment also reduced his taxable income. The Tax Court and the Fifth Circuit both agreed that the tax results he claimed followed directly from those unambiguous tax rules. Yet those courts nevertheless invoked the economic substance doctrine to override the clear effect of the applicable statutes and regulations, and disallow the resulting deduction.

This Court should grant review to resolve the circuit split over whether the economic substance doctrine may be invoked to void the results of clear and unambiguous provisions, or is a more limited tool for interpreting ambiguous text. And this Court should reverse, because the text-overriding approach to the economic substance doctrine is fundamentally at odds with the proper role of the courts and the basic principles of statutory interpretation that apply to every other title of the United States Code.

The petition should be granted.

A. Legal Background

1. The Economic Substance Doctrine

a. The economic substance doctrine is generally traced to a series of decisions of this Court bookended by *Gregory v. Helvering*, 293 U.S. 465 (1935), and *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

In *Gregory*, the taxpayer owned all the stock of one corporation (United Mortgage Corporation), which in turn held shares of another (Monitor Securities Corporation). 293 U.S. at 467. The taxpayer wanted to sell the Monitor shares for personal profit, but she also wanted to reduce the taxes that would have been due if United had sold the shares (one taxable event) and then distributed the proceeds to her as a dividend (another taxable event). *See id.* To that end: The taxpayer formed a new corporation, caused United to contribute the Monitor shares to it, dissolved it, and distributed the Monitor shares to her in liquidation. *Id.* Then she took the position that this transaction was a "'reorganization' under section 112(g) of the Revenue Act of 1928," resulting in a tax-free distribution of the Monitor shares to her and a personal gain on her sale of the shares. *See id.*

The Commissioner argued that this transaction was not a "reorganization" within the meaning of section 112(g), claiming that the transaction "was without substance and must be disregarded." *Id.* This Court acknowledged that "if a reorganization in reality was effected," the taxpayer should prevail. *Id.* at 469. But, the Court said, a statutory "reorganization" involves "a transfer of assets . . . made 'in pursuance of a plan of reorganization' . . . *of corporate business*; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either." *Id.* (emphasis added). Since the new corporation was "nothing more than a contrivance," and the transaction had "no business or corporate purpose," the Court held, there was no "reorganization" as that term was used in section 112(g). *Id.* at 469–70.

Forty years later, in *Frank Lyon*, this Court identified circumstances in which this focus on the "substance" of the transaction would *not* prevent invocation of favorable tax provisions. There, a bank wanted to build a new bank and office building, but could not own it because of banking restrictions. *Frank Lyon*, 435 U.S. at 563–64. Instead, the bank entered into a "sale-and-leaseback" with the taxpayer—*i.e.*, the taxpayer purchased the building from the bank and then leased the building back to the bank. *Id.* at 564–68. Consistent with a leasing arrangement, the taxpayer reported the rental income from the bank, interest expense, and depreciation deductions on its tax returns. *Id.* at 568.

The Commissioner took the position that the "transaction in its entirety should be regarded as a sham." *Id.* at 573. Accordingly, he determined that, for tax purposes, the taxpayer was "not the owner" of the building who was entitled to take depreciation deductions. *Id.* at 568, 572–73. But this Court rejected any notion that the transaction was a "sham." *Id.* at 580–81. In doing so, it emphasized that the tax law allows a taxpayer to take depreciation deductions "for the consumption of . . . capital." *Id.* at 581. The taxpayer had committed its capital to the building—and was liable for a third-party loan—so it was the "owner" entitled to claim depreciation deductions, even if the terms and structure of the transaction had been shaped by tax considerations. *See id.*

b. In the 40 plus years since *Frank Lyon,* lower courts have adopted conflicting views on the scope and limits of the economic substance doctrine. But when the doctrine applies they primarily assess two things: Whether the transaction had *objective* non-tax economic substance at the time it was consummated and whether the taxpayer had a *subjective* non-tax purpose for entering into it. *See, e.g.*, *Klamath Strategic Inv. Fund ex rel. St. Croix Ventures v. United States*, 568 F.3d 537, 544 (5th Cir. 2009). As discussed below (at 13–22), some courts apply the doctrine only as a means of interpreting and applying tax provisions in circumstances where their application is otherwise open to debate—*e.g.*, in deciding whether a particular transaction qualifies as a "reorganization" that might trigger tax benefits. Other courts, however, have invoked the doctrine as a means of voiding any tax results they deem unacceptable, even if the results are the product of clear and unambiguous tax rules.

c. In 2010, Congress enacted a "clarification" of the economic substance doctrine. 26 U.S.C. § 7701(*o*). Section 7701(*o*) was designed to make the *content* of the doctrine more uniform, *see* H.R. Rep. No. 111-443, pt. 1, at 295 (2010), but explicitly provides that the doctrine is *applicable* only when "the economic substance doctrine is relevant to [the] transaction" as determined by case law, "as if this subsection had never been enacted." 26 U.S.C. § 7701(*o*)(5)(C). Thus, in cases involving application of the economic substance doctrine to tax years both before (as in this case) and after adoption of Section 7701(*o*), the doctrine's application depends entirely on judicially developed rules about its relevance.

2. Background Tax Principles

The courts in this case invoked the economic substance doctrine in its broadest form to override the results of unambiguous, mechanical provisions of tax law. We begin by explaining the background tax principles (none of which is disputed) governing the transaction that gave rise to this dispute.

a. *Taxation of United States and foreign persons*. The Internal Revenue Code generally taxes United States persons—including U.S. citizens and domestic corporations—on their worldwide income. *Mertens Law of Federal Income Taxation* § 47:3 (Westlaw June 2019 update) (*Mertens*); *see, e.g.*, 26 U.S.C. §§ 1, 11, 7701(a)(30). By contrast, the Code generally does not tax nonresident aliens or foreign corporations, except on income sufficiently connected to the United States. *Mertens* § 47:3; *see* 26 U.S.C. §§ 2(d), 11(d), 871, 882.

These principles potentially allow for indefinite deferral of federal income tax on foreign income. A domestic corporation could, for example, conduct its foreign operations through a foreign subsidiary; foreign income earned by that subsidiary would normally escape the Code's reach. That income would be subject to federal income tax only when it is distributed to the domestic parent corporation, as through a dividend. *See Mertens* § 45E:1.

Special rules thus limit this deferral of income for "controlled foreign corporations." A controlled foreign corporation is a foreign corporation majority owned by "United States shareholders," defined as U.S. persons who each own at least 10 percent of the stock. *See* 26 U.S.C. §§ 951(b), 957(a). Controlled foreign corporations' income, unlike other foreign corporations' income, is effectively subject to federal income tax regardless of where it is earned: Each year, the United States shareholders must include in taxable income their pro rata share of a subset of the controlled foreign corporation's income (known as "subpart F income"), even if the controlled foreign corporation does not actually distribute any money to them. *Id.* § 951(a); *see Mertens* § 45E:1. Before 2018, however, that rule applied only if a foreign corporation was a controlled foreign corporation "for an uninterrupted period of 30 days or more during [the] taxable year" (the 30-day rule). 26 U.S.C. § 951(a)(1) (2000), *amended by* Pub. L. No. 115-97, § 14215(a), 131 Stat. 2054, 2218 (2017).

b. *Pass-through entities and the "check the box" regulations.* Some legal entities are not subject to federal income tax at the entity level, even if they are formed under domestic law and earn income in the U.S. Those entities—most notably, partnerships and

S corporations[2]—instead "pass through" their income to their owners, who must report that income on their own tax returns and pay tax on it. *Id.* §§ 701, 1366(a)(1). Some entities, such as limited liability companies, have flexibility in how they are taxed under the Code. The "check the box" regulations allow those entities to elect entity-level taxation or pass-through taxation. 26 C.F.R. §§ 301.7701-2(a), 301.7701-3(a). That flexibility extends to many kinds of foreign entities. *See id.* § 301.7701-3(a)–(d).

B. Facts And Procedural History

1. Keith Tucker was the chief executive officer of a national mutual fund and financial services company, Waddell & Reed Financial, Inc. App. 3a. Through a Waddell-sponsored program, he received financial planning and tax services from professionals at the accounting firm KPMG. *Id.* In 2000, KPMG anticipated that Mr. Tucker would exercise Waddell stock options, realizing about $41 million of taxable income. *Id.* at 3a–4a, 8a. Mr. Tucker told KPMG that he was interested in diversifying his investments into riskier assets with a greater upside. *Id.* at 25a. When KPMG offered potential investment options that could also mitigate his tax bill for the year, he indicated interest—but made clear he would not participate in an abusive tax shelter. *Id.* at 25a–28a.

At the recommendation of his advisors, Mr. Tucker ultimately made several investments. *Id.* at 44a, 83a.

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[2] By default, a corporation is a C corporation, or a corporation subject to subchapter C of the Internal Revenue Code and the entity-level corporate income tax. 26 U.S.C. § 1361(a)(2). An S corporation is a corporation that has opted into subchapter S of the Code and is therefore not subject to corporate income tax. *Id.* §§ 1361(a)(1), 1363(a).

One, described further below, had a 40 percent probability of a $1.5 million profit and—through the interplay of several clear, unambiguous, and mechanical features of the tax law—was expected to have favorable tax consequences for him. *Id.* at 30a, 68a. That transaction involved the following steps:

- In December 2000, Mr. Tucker formed Sligo (2000) Company, Inc. (Sligo), which elected S corporation status, and invested $2,024,700 in it. Sligo in turn purchased 99 percent of the shares of Epsolon, Ltd. (Epsolon), an Irish entity, which by default became a controlled foreign corporation. *Id.* at 4a–5a; *see* 26 U.S.C. § 957(a) (2000); 26 C.F.R. § 301.7701-3(b)(2)(i)(B) (2000).
- On December 20, 2000, Epsolon traded options tied to the value of the U.S. dollar. It bought four options and sold four options, collecting options premiums of $157,500,000 and paying premiums of $156,041,001. The profitability of this transaction depended on the volatility of the U.S. dollar. There was a 40 percent probability that Epsolon would get to keep the difference of $1,458,999. App. 5a–6a, 33a–35a.
- On December 21, 2000, the value of the U.S. dollar changed, which caused four of Epsolon's options to appreciate in value. Epsolon closed those options for a total gain of $51,260,455. Epsolon also reinvested the proceeds in four new options for a net premium of $50,602,393. *Id.* at 6a, 36a–37a.
- On December 27, 2000, Epsolon elected to be treated as a partnership for federal income tax purposes, as the check-the-box regulations

permit. *See* 26 C.F.R. § 301.7701-3(c)(1)(i) (2000). That election also ended Epsolon's controlled foreign corporation status. Since Epsolon was a controlled foreign corporation for fewer than 30 days, Sligo (the only United States shareholder) was not required to include its share of Epsolon's income (the gain from the options sold) in its taxable income. App. 6a–7a, 32a; *see* 26 U.S.C. § 951(a)(1) (2000).

- Due to Epsolon's partnership election, it was deemed to have liquidated and distributed its assets and liabilities to its shareholders (primarily Sligo), who were then deemed to have contributed those assets and liabilities to a new partnership. 26 C.F.R. § 301.7701-3(g)(1)(ii) (2000). Normally, Sligo (and thereby Mr. Tucker) would have "include[d] in income as a deemed dividend the all earnings and profits amount with respect to its stock in" Epsolon, that is, the gain from the options sold. *Id.* § 1.367(b)-3(b)(3)(i) (2000). At the time, though, a regulation gave Sligo the option to "recognize the gain . . . that it realize[d] in the exchange" instead. *Id.* § 1.367(b)-3T(b)(4)(i)(A) (2000). That amount was zero, so Sligo elected to recognize it instead of the higher "all earnings and profits amount." App. 6a & n.6.
- On December 28, 2000, Epsolon closed four options for a total loss of $39,584,511. Under general partnership tax principles, 99 percent of that loss was allocated to Sligo, and thus to Mr. Tucker. Mr. Tucker included a loss of $39,188,666 on his 2000 tax return. App. 7a, 45a–46a.

- On January 8, 2001, the remaining four options expired worthless. Mr. Tucker reported related losses of $13,742,247 on his 2001 tax return; those losses are not at issue here. *Id.* at 46a & n.6.

A law firm provided an opinion that this transaction "would more likely than not withstand IRS scrutiny." *Id.* at 42a. Despite that prediction, the Internal Revenue Service disallowed the 2000 loss, assessed a tax deficiency of $15,518,704, and imposed penalties of $6,206,488.[3] *Id.* at 8a. Mr. Tucker petitioned the Tax Court for redetermination.

2. In the Tax Court, Mr. Tucker conceded that the 2000 loss was limited to $2,024,700, or his basis (equal to the amount he had invested) in Sligo's stock. *Id.* at 7a, 50a; *see* 26 U.S.C. § 1366(d)(1) (2000). He contended, however, that that loss should be allowed: The transaction was bona fide and had significant profit potential ($1.5 million), and the tax consequences resulted from a mechanical application of clear and unambiguous tax rules. App. 53a–58a. The Commissioner made several counterarguments, but the court focused on his argument about the economic substance doctrine. *Id.* at 51a–52a.

The Tax Court acknowledged that every step in the transaction at issue complied with the tax law, and that applying the tax law as written would result in recognition of the loss on the options trades without recognition of the gain. *Id.* at 53a–58a, 60a–63a. Yet the court denied that treatment because Mr. Tucker

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[3] The IRS also disallowed the 2001 loss. That loss is the subject of a separate lawsuit in the Court of Federal Claims, No. 1:05-cv-00999-MMS, which has been stayed pending the outcome of this case.

had "cite[d] no legislative, regulatory, or other authority indicating that Congress intended such a result. Rather, legislative history and congressional intent contradict [his] argument." *Id.* at 61a.

The Tax Court then invoked the economic substance doctrine, which, it said, "permits a court to disregard a transaction—even one that formally complies with the Code—for Federal income tax purposes." *Id.* at 65a. Applying the doctrine, the court determined that, objectively, the transaction's potential profit and actual losses were too small relative to the tax losses claimed, *id.* at 70a, 79a; and, subjectively, Mr. Tucker had "entered into the Epsolon options for the sole purpose of reducing his income tax," *id.* at 81a. Accordingly, the court refused to allow the tax loss at issue. *Id.* at 21a.[4]

3. Mr. Tucker appealed to the Fifth Circuit, where he renewed his argument that the economic substance doctrine is inapplicable altogether in this case because the transaction complied with a literal reading of the Code. *Id.* at 10a. The court rejected that argument. It did not matter, the court said, that the transaction "technically complied with [the] tax laws"; "[i]t was appropriate . . . to apply the economic substance doctrine to the transaction to determine whether 'what was done, apart from the tax motive, was the thing which the statute intended.'" *Id.* at 11a, 13a (citation omitted). Then, applying the doctrine, the Fifth Circuit refused to recognize the results that stemmed from the application of the tax laws,

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[4] The Tax Court nevertheless held that Mr. Tucker had reasonably relied on his advisors and thus rejected the Commissioner's request for penalties. *Id.* at 88a–93a. The Commissioner did not appeal that determination.

"because there was no reasonable possibility of profit and there was no actual economic effect" in the underlying transaction. *Id.* at 19a.

REASONS FOR GRANTING THE WRIT

This case meets all the traditional criteria for certiorari. *See* Sup. Ct. R. 10(a). The circuits are split on the scope of the economic substance doctrine: Some courts hold that the doctrine is only a tool for interpreting the meaning of ambiguous text (and is inapplicable where the text is clear), whereas others treat the doctrine as a license to disregard clear and unambiguous rules whenever a court believes the result of applying such rules is abusive. The Fifth Circuit's decision in this case is emblematic of the text-overriding approach; the court invoked the doctrine to void the tax result that indisputably followed from the operation of unambiguous rules. Whether the economic substance doctrine may be invoked to override unambiguous tax laws is a recurring question of exceptional importance, implicating both the proper role of the courts in interpreting and giving effect to the law and the ability of taxpayers to rely on the law as written.

A. The Circuits Are Split On The Proper Role, And Limitations, Of The Judge-Made Economic Substance Doctrine

This Court's intervention is needed to resolve a circuit split over the proper role of the economic substance doctrine. Some circuits, including the D.C. and Sixth Circuits, treat the doctrine as a way to understand particular tax rules when the text itself requires reference to economic substance (*e.g.*, by employing a flexible term like "reorganization")—but hold that it may not be invoked to supplant unambiguous rules. Other circuits, including the Third, Fifth, and Federal Circuits, use the doctrine to override clear text when they decide the *consequences* of applying a mechanical tax rule would contravene Congress's wishes. They do so, moreover, even in circumstances where the rule in question explicitly allows the taxpayer to elect between differing tax treatments—effectively taking away on the back end an option that the tax law's clear terms unambiguously offered on the front end. The Court's intervention is needed to resolve that split.

1. The D.C. Circuit's decision in *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992), exemplifies the position that the doctrine is properly limited to a tool for interpreting ambiguous text. There, the taxpayer was a commodities dealer whose trading in "straddles"—offsetting financial positions in the same commodity—had produced tax losses without economic losses. *Id.* at 1231–33, 1236. In identical circumstances, several courts had refused to allow the tax losses because the trading, they said, lacked economic substance. *Id.* at 1233–34.

The D.C. Circuit, by contrast, held that it was required to give effect to the law. The tax provision in question, Section 108 of the Tax Reform Act of 1984 (as amended), (1) allowed "any loss" from trading straddles if "incurred in a trade or business"; and (2) treated "'any loss incurred by a commodities dealer in the trading of commodities . . . as a loss incurred in a trade or business.'" *Id.* at 1234–35 (citation omitted); *see* 26 U.S.C. § 1092 note (1988). The D.C. Circuit concluded that Section 108 applied by its plain terms and allowed the losses the taxpayer had incurred—

notwithstanding the Commissioner's economic substance objection. *Horn*, 968 F.2d at 1234–35.

The D.C. Circuit observed that there were "persuasive arguments that section 108(b) ought not say what it says—that the statute as we would read it authorizes a tax benefit for a small class of taxpayers who may have engaged in the transactions at issue for no reason other than the tax benefits." *Id.* at 1234. But, the court explained, "Congress has the power to authorize these transactions, whether or not they are economic shams." *Id.* at 1236. The court clarified that the economic substance doctrine is, at most, a "judicial device[] for divining and effectuating congressional intent, not for supplanting it." *Id.* at 1234. Noting that the economic substance-based reasoning that other courts had employed "read [§ 108(b)] completely out of existence," the D.C. Circuit declined to follow those decisions. *Id.*

The Sixth Circuit has adopted the same view. *See Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2017). *Summa Holdings* concerned the tax benefits achieved by using two tax-favored vehicles, Roth IRAs[5] and "domestic international sales corporations" (DISCs).[6] *Id.* at 781–82. A family

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[5] "Roth IRAs" benefit taxpayers because allowable annual contributions to a Roth IRA grow tax-free, and the taxpayer may, upon retirement, withdraw the balance without incurring any tax liability. *See Summa Holdings*, 848 F.3d at 783.

[6] A DISC is a "congressionally innovated corporation" designed "to incentivize companies to export their goods by deferring and lowering their taxes on export income." *Summa Holdings*, 848 F.3d at 781–82. An exporter may set up a DISC and pay it commissions, which are tax-deductible to the exporter and nontaxable to the DISC. *See id.* at 782. The DISC's

contributed the maximum amount allowed ($3,500) to two Roth IRAs, which invested in a DISC the family also set up. *Id.* at 783. Over a seven-year period, the DISC paid $5.1 million in dividends to the Roth IRAs, where the money could grow—and eventually be withdrawn—tax-free. *Id.* at 784. The Commissioner asked the court to set aside this arrangement, claiming it was just a scheme "to sidestep the contribution limits on Roth IRAs." *Id.* at 784–85.

The Sixth Circuit refused. To start, all agreed that the plain text of "[t]he Internal Revenue Code allowed [the family] to do what [it] did": Roth IRAs and DISCs are creatures of statute, the Code lets Roth IRAs invest in DISCs, and all applicable taxes were paid. *Id.* Nevertheless, the Commissioner claimed "a right to reclassify Code-compliant transactions" to comport with his view of their economic substance. *Id.* The problem, the court said, was that Roth IRAs and DISCs are "designed for tax-reduction purposes" and "have no economic substance at all"—so "economic-substance principles . . . do not give the Commissioner purchasing power here." *Id.* at 786. Holding otherwise, the court concluded, would allow "the Commissioner to place labels on transactions to avoid textual consequences he doesn't like." *Id.* at 787.

The Sixth Circuit expressed grave reservations about the separation-of-powers implications stemming from the use of economic substance in this broad form. As Judge Sutton observed in his opinion for the court: "If the government can undo transactions that the terms of the Code expressly authorize, it's fair to ask what the point of making

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shareholders are liable for taxes on DISC dividends, among other things. *See id.*

these terms accessible to the taxpayers and binding on the tax collector is." *Id.* at 782. The court added that "it's odd to reject a Code-compliant transaction in the service of general concerns about tax avoidance." *Id.* at 787. "Before long," the court observed, "allegations of tax avoidance begin to look like efforts at *text avoidance.*" *Id.* (emphasis added).[7]

2. In sharp contrast, other circuits have held that the clear terms of tax laws are *not* "binding on the tax collector." *Id.* at 782. These courts apply the economic substance doctrine before—and, often, without—considering the statute or regulation at

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[7] The Fifth Circuit below distinguished *Summa Holdings* because it thought that the rules at issue here (unlike those at issue there) were not "designed for tax-reduction purposes." App. 13a. The court further surmised that the history of the 30-day rule and the check-the-box regulations suggested that "Mr. Tucker's manipulation of the rules was contrary to Congress' intent." *See id.* at 14a. But, as explained below (at 23–31), the Fifth Circuit's elevation of history and purpose over text flouts the usual principles of statutory interpretation, and thus, in fact, underscores the conflict with *Summa Holdings*. Even setting that aside, the court's analysis of purpose and congressional intent is unsound. The 30-day rule had obvious "tax-reduction purposes" for foreign corporations that were controlled foreign corporations for fewer than 30 days. In fact, the Senate Report cited by the court accompanied legislation that specifically *added* the 30-day rule to narrow the scope of the controlled foreign corporation rules. *See* S. Rep. No. 87-1881, at 79 (1962); *infra* at 20 n.8. The check-the-box regulations are likewise "designed for tax-reduction purposes": They allow taxpayers to opt out of entity-level taxation entirely. The preamble cited by the court, far from contradicting that point, simply notes that the Treasury Department might "take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions." 61 Fed. Reg. 66,584, 66,585 (Dec. 18, 1996).

issue, and invoke the doctrine to override tax rules, no matter how clear, unambiguous, and mechanical.

The Third Circuit's decision in *Internal Revenue Service v. CM Holdings, Inc. (In re CM Holdings, Inc.)*, 301 F.3d 96 (3d Cir. 2002), is emblematic of this approach. The question there was whether the taxpayer could deduct interest paid on loans backed by company-owned life insurance. *Id.* at 99–101. Resolving that question involved turning to several statutes. *Id.* at 101–02. But, the court said:

> We can forgo examining the intersection of these statutory details, for . . . courts have looked beyond taxpayers' formal compliance with the Code and analyzed the fundamental substance of transactions. Economic substance is a prerequisite to the application of any Code provision allowing deductions. . . . It is the Government's trump card; even if a transaction complies precisely with all requirements for obtaining a deduction, if it lacks economic substance it "simply is not recognized for federal taxation purposes, for better or for worse."

Id. at 102 (quoting *ACM P'ship v. Commissioner*, 157 F.3d 231, 261 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999)). The Third Circuit ultimately disallowed the interest deduction for lack of economic substance. *Id.* at 102–07. Moreover, the court upheld penalties against the taxpayer, reasoning that the taxpayer had "no substantial authority" for taking the deduction—without even considering whether the plain terms of the statute granted such authority. *Id.* at 108.

The Federal Circuit has also invoked this text-overriding version of the economic substance doctrine. *See Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 549 U.S. 1206 (2007). In *Coltec*, the taxpayer claimed a high basis in the stock of a subsidiary that it sold for a nominal sum, producing a tax loss. *Id.* at 1343. The Commissioner contended that the taxpayer should have reduced its basis by the amount of contingent liabilities the subsidiary had assumed. *Id.* at 1345–46. The Federal Circuit painstakingly reviewed each relevant statute and concluded that "under the literal terms of the statute the basis" was correct, and the loss was proper. *Id.* at 1351. Indeed, the court even found that a specific antiabuse statute Congress had enacted—which applies when "liabilities are assumed principally for tax avoidance purposes"—did not cover the scenario before it. *Id.* at 1350; *see* 26 U.S.C. § 357(b)(1). But the court nevertheless invoked the economic substance doctrine to vitiate the transaction and, thus, the result that followed from the plain and unambiguous terms of the statute. *Coltec Indus.*, 454 F.3d at 1351–60.

Other circuits have also invoked the economic substance doctrine in a similar, law-overriding fashion, albeit in a more conclusory manner. *See, e.g.*, *Bank of N.Y. Mellon Corp. v. Commissioner*, 801 F.3d 104, 113 (2d Cir. 2015) ("AIG argues that the economic substance doctrine cannot be applied to disallow foreign tax credits that comply with all statutory and regulatory requirements. . . . We disagree."), *cert. denied*, 136 S. Ct. 1377 (2016); *Kirchman v. Commissioner*, 862 F.2d 1486, 1491 (11th Cir. 1989) ("The analysis of whether something [lacks economic substance] must occur before analysis of the [statutory provision].").

3. The difference in these conflicting approaches matters here. Clear, unambiguous, and mechanical rules allowed Mr. Tucker, Sligo, and Epsolon to do exactly what they did. Indeed, at least two of those rules offered tax treatment options that any reasonable taxpayer would have exercised to lower his taxes. The Tax Court and Fifth Circuit disallowed the results dictated by those rules, not because they disagreed with the interpretation of the rules, but because they believed it proper to *override* them using the broad version of the economic substance doctrine.

There is no dispute about the content or meaning of any of the three tax rules Mr. Tucker utilized:

- The 30-day rule kept a foreign corporation's United States shareholders from recognizing their pro rata share of the corporation's subpart F income unless the corporation was a controlled foreign corporation "for an uninterrupted period of 30 days or more during [the] taxable year." 26 U.S.C. § 951(a)(1) (2000). That bright-line rule had no conditions or exceptions, and applied regardless of the amount of income at issue or other underlying economics.[8]

[8] The mechanical 30-day rule was no accident. The original House-passed controlled foreign corporation rules required income inclusion "if the foreign corporation was a [controlled foreign corporation] *on any one day* of the taxable year." H.R. Rep. No. 87-2508, at 30 (1962) (Conf. Rep.) (emphasis added). The Senate's addition of the 30-day rule thus reflected an intentional choice—which the courts below effectively disregarded even though it had been in place for over

- The check-the-box regulations are similarly mechanical. Before their promulgation, "many states ha[d] revised their statutes" to "narrow[] considerably the traditional distinctions between corporations and partnerships" (*i.e.*, between entities that are subject to entity-level taxation and those that are not), causing "taxpayers and the IRS [to] expend considerable resources on classification issues." 61 Fed. Reg. 21,989, 21,989–90 (May 13, 1996). The check-the-box regulations adopted a "much simpler," "elective" approach. *Id.* at 21,990. That is, they give taxpayers a choice in how they are taxed—which taxpayers will naturally use to their benefit—and are "all form and no substance." *Summa Holdings*, 848 F.3d at 786. Moreover, they expressly allow elective changes in classification and spell out the consequences in detail, without even hinting that elections with a tax-reduction purpose are somehow invalid. *See* 26 C.F.R. § 301.7701-3(c)(1)(i), (g)(1)(ii) (2000).
- The last rule at issue was of a piece. At the time of Mr. Tucker's transactions, an applicable regulation "permitted an exchanging shareholder to elect to recognize the gain . . . that it realize[d] in the exchange . . . rather than include the all earnings and profits amount in income." 65 Fed. Reg. 3586, 3587 (Jan. 24, 2000); *see* 26 C.F.R. § 1.367(b)-

50 years. *See* Pub. L. No. 87-834, § 12(a), 76 Stat. 960, 1006 (1962).

> 3T(b)(4)(i)(A) (2000).[9] That regulation contained no limitations or exceptions, and Sligo understandably elected to recognize the (lower) "gain . . . realized" instead of the (higher) "all earnings and profits amount." Any logical taxpayer would have done the same.

Neither court below pointed to an ambiguity in any of these rules that it was called upon to interpret. On the contrary, the Fifth Circuit recognized that Mr. Tucker "technically complied with [these] tax laws" and that the transaction "was consistent with the Code's language." App. 11a. In the D.C. and Sixth Circuits, that would have been dispositive. But the Fifth Circuit held otherwise, embracing a judge-made veto power applicable whenever—as the First Circuit long ago put it—following the text "would produce in the particular instance a result distasteful to the court." *Fabreeka Prods. Co. v. Commissioner*, 294 F.2d 876, 877 (1st Cir. 1961). Ultimately, the court concluded that it was appropriate to void the literal application of these laws—not because the result contravened the language of any statute or rule, but rather because the court thought that Congress would not have condoned that result. App. 14a.

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[9] That election was promulgated by a proposed regulation in 1977 and modified in 1991. 42 Fed. Reg. 65,152, 65,159–60 (Dec. 30, 1977); 56 Fed. Reg. 41,993, 42,009–11 (Aug. 26, 1991). The final regulation "d[id] not adopt" it, but the Treasury Department kept it in place as a temporary regulation for an extra year—during which the transactions at issue here took place—"to provide taxpayers an opportunity to comment on th[at] change." 65 Fed. Reg. 3589, 3593 (Jan. 24, 2000).

That outcome-determinative conflict among the courts of appeals warrants this Court's review.

B. The Fifth Circuit Erred In Invoking The Economic Substance Doctrine To Override Clear, Unambiguous, And Mechanical Tax Rules

This Court's review is particularly needed because the majority approach in the lower courts, employed by the Fifth Circuit here, is fundamentally flawed. That text-overriding version of the economic substance doctrine is impossible to square with this Court's approach to statutory and regulatory interpretation, in the tax context and elsewhere. And it is profoundly at odds with the separation of powers between the legislative and judicial branches.

1. The Fifth Circuit's broad conception of the economic substance doctrine deeply conflicts with the presumption that Congress intends the results of clear and unambiguous laws. This Court has "stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there. When the words of a statute are unambiguous, then, this first canon is also the last: 'judicial inquiry is complete.'" *Barnhart v. Sigmon Coal Co.*, 534 U.S. 438, 461–62 (2002) (citations omitted). Thus, this Court "enforce[s] plain and unambiguous statutory language according to its terms." *Hardt v. Reliance Standard Life Ins. Co.*, 560 U.S. 242, 251 (2010). Indeed, this Court regularly refuses "to rescue Congress from its drafting errors, and to provide for what we might think . . . is the preferred result." *Lamie v. United States Trustee*, 540 U.S. 526, 542 (2004) (alteration in original) (citation omitted). This Court has never carved out any special

exception from these elementary principles of separation of powers for tax cases.[10]

The "text avoidance" version of the economic substance doctrine, *Summa Holdings*, 848 F.3d at 787, also represents an improper "judicial effort to enforce the statutory *purpose* of the tax code," rather than the text, *Coltec Indus.*, 454 F.3d at 1353 (emphasis added). As this Court has emphasized, however, "[t]he best evidence of [statutory] purpose *is* the statutory text." *West Va. Univ. Hosps., Inc. v. Casey*, 499 U.S. 83, 98 (1991) (emphasis added). The text-overriding version of the economic substance doctrine is a singular departure from that fundamental principle—but there is no warrant for such tax exceptionalism. *Cf. Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 56 (2011) (holding that the *Chevron* doctrine applies in the tax context just as it does elsewhere).

To be sure, the economic substance doctrine was initially conceived in a day when courts more readily sought to divine a statute's purpose from things like legislative history, rather than simply giving effect to

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[10] The same goes for regulations. Valid regulations extend, and have the same legal effect as, statutes. *See Chrysler Corp. v. Brown*, 441 U.S. 281, 295 (1979). And, whatever leeway courts have in interpreting *ambiguous* regulations, when a regulation is unambiguous, it "just means what it means—and the court must give it effect, as the court would any law." *Kisor v. Wilkie*, No. 18-15, 2019 WL 2605554, at *8 (U.S. June 26, 2019). That is also true for agencies, which must follow their own rules. *See Ballard v. Commissioner*, 544 U.S. 40, 59 (2005). Of course, an agency may amend or repeal its regulations to address perceived flaws or shortcomings, as long as it complies with the requirements of rulemaking—but it may not ignore a regulation as written. *See id.*; *Nat'l Envtl. Dev. Ass'n's Clean Air Project v. EPA*, 752 F.3d 999, 1009 (D.C. Cir. 2014).

text. *Cf., e.g.*, *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 412 n.29 (1971). But that is hardly a sufficient justification for elevating purpose over text today. Just as this Court now emphasizes the primacy of text elsewhere, *see, e.g.*, *Baker Botts L.L.P. v. ASARCO LLC*, 135 S. Ct. 2158, 2169 (2015) ("Our job is to follow the text even if doing so will supposedly 'undercut a basic objective of the statute' . . . ." (citation omitted)), so it does with respect to the tax laws, *see Gitlitz v. Commissioner*, 531 U.S. 206, 220 (2001) ("Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern."). Yet, notwithstanding the Court's repeated admonitions that the text *is* the law, the Fifth Circuit and other lower courts have continued to apply the economic substance doctrine to disregard Code-compliant transactions, to effectuate their view of an unstated statutory purpose. *See CM Holdings*, 301 F.3d at 102; App. 11a.

Elevating a search for Congress's supposed "purpose" over text is *particularly* inappropriate when it comes to tax law. The Internal Revenue Code reflects innumerable tradeoffs about whom to tax, what to tax, and how much to tax. *See* David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 Cornell L. Rev. 1627, 1631–32 (1999). It serves a variety of non-tax purposes as well, such as providing benefits to certain classes of people and incentivizing particular kinds of economic activity. *See, e.g.*, 26 U.S.C. § 42 (credit for construction or rehabilitation of affordable housing); Leandra Lederman, *W(h)ither Economic Substance?*, 95 Iowa L. Rev. 389, 395 (2010) ("[T]he federal income tax system does not try *only* to measure taxpayers' taxable income"; "[i]t also contains provisions expressly designed to alter taxpayers' behavior." (emphasis added)). The "text avoidance" version of the economic substance doctrine, however, unrealistically presumes that Congress always acts with only one purpose—tax maximization—in mind. *See Summa Holdings*, 848 F.3d at 787–88.

The fact that the text-overriding version of the economic substance doctrine rests on that flawed presumption without any textual hook is reason enough to reject it. *Cf. CTS Corp. v. Waldburger*, 573 U.S. 1, 12 (2014) ("[N]o legislation pursues its purposes at all costs." (citation omitted)). But it is even more problematic since it can cause courts to reverse the effects of unquestionably taxpayer-friendly rules. Two of the rules at issue here, for example, allow taxpayers to elect between various tax treatments—an election that any rational taxpayer would use to reduce tax. The courts below, however, refused to give effect to those elections precisely *because* they had been used to reduce tax.

Nor is there any special justification for a text-overriding economic substance doctrine in the tax arena. Congress and the Treasury Department are active in the tax field. They can change tax rules just as easily as they can change other rules (and they do). *See Lamie*, 540 U.S. at 542 ("If Congress enacted into law something different from what it intended, then it should amend the statute to conform it to its intent."). Moreover, Congress can enact—and has enacted—specific rules to curb the potential for abuse. *See, e.g.*, 26 U.S.C. § 269(a) (disallowing tax benefits from an acquisition when "the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax"). There is simply no need for courts to set aside the consequences of applying clear, unambiguous, and mechanical tax rules just because, to their own noses, "the scheme in question smells bad." *ACM P'ship*, 157 F.3d at 265 (McKee, J., dissenting). After all, courts' "inquiry is cerebral, not visceral. To the extent that the Commissioner is offended by [certain] transactions he should address Congress and/or the rulemaking process, and not the courts." *Id.*

2. The text-overriding economic substance doctrine not only is at odds with the principles that govern the interpretation of statutes generally, but also contravenes foundational principles that govern the interpretation of *tax* statutes in particular.

For example, this Court has long recognized that, "[i]n the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out." *Gould v. Gould*, 245 U.S. 151, 153 (1917). This "established rule" is especially important given that taxpayers are expected to—and do—rely on the tax laws in ordering their affairs. *See Summa Holdings,* 848 F.3d at 781–82. But the text-overriding economic substance doctrine does just the opposite—it allows courts to ignore "the clear import of the language used" and disregard the results of Code-compliant transactions.

Similarly, while this Court recognizes that taxpayers may "structure their business affairs . . . to minimize taxes," *Commissioner v. First Sec. Bank of Utah, N.A.*, 405 U.S. 394, 398 n.4 (1972), and does not inquire into taxpayers' motives for entering into certain transactions, *see, e.g.*, *Superior Oil Co. v. Mississippi ex rel. Knox*, 280 U.S. 390, 395–96 (1930), lower courts frequently ignore these principles when considering invoking the economic substance doctrine. Not only is the taxpayer's motivation relevant to lower courts' formulation of the economic substance doctrine, but it is often the driving factor.

3. Nothing in this Court's case law requires courts to treat economic substance as a categorical, text-overriding demand of the tax law. On the contrary, if anything, this Court has made clear that economic substance is *not* a universal command of the Code.

In *Cottage Savings Association v. Commissioner*, thrifts had experienced significant losses on mortgage interests. 499 U.S. 554, 556 (1991). Their regulator allowed them to exchange "substantially identical" mortgage interests—without recognizing a loss for regulatory purposes—for the avowed purpose of "generat[ing] tax losses . . . that would not substantially affect the economic position of the [thrifts]." *Id.* at 557. This Court held that the thrifts were entitled to recognize the losses, because the assets exchanged were "materially different": Even though the mortgage interests were economically indistinguishable, they entailed "legally distinct entitlements." *Id.* at 566. More to the point here, the Court specifically rejected the "argu[ment] that properties are 'materially different' only if they differ in economic substance," instead adopting "a much less demanding and less complex test." *Id.* at 562. In other words, under *Cottage Savings*, "economic substance" matters only if the rule requires it.

The cases most often cited by lower courts to support the text-overriding economic substance doctrine—primarily, *Gregory* and *Frank Lyon*—are not to the contrary. In *Gregory*, the Court held merely that a "reorganization" for purposes of the provision at issue there meant a transaction with an economically meaningful business purpose. 293 U.S. at 469; *see, e.g.*, *Mertens* § 43:29. In *Frank Lyon* the Court likewise looked to the statute to determine who qualified as an "owner" entitled to depreciation deductions, and held that the taxpayer qualified because it had committed its capital to constructing the building. 435 U.S. at 580–81; *see Nebraska Dep't of Revenue v. Loewenstein*, 513 U.S. 123, 133 (1994) (characterizing *Frank Lyon* as being about the concept of "ownership" and whether to characterize the transaction "as a 'sale-and-leaseback' rather than a 'financing transaction'"); *Boulware v. United States*, 552 U.S. 421, 429 (2008) (citing *Frank Lyon* for the proposition that economic substance is useful when considering particular "tax classifications like 'dividend' and 'return of capital'").

Both cases are thus narrow decisions that, at most, use economic substance as a way of understanding tax terms "that draw their content from life."[11] Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. Chi. L. Rev. 859, 879 (1982). Neither case created a general principle of tax law that allows courts to disregard the tax results produced by clear, unambiguous, and mechanical rules.

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[11] Other cases frequently cited by the lower courts are similar. In *Higgins v. Smith*, this Court simply held that the taxpayer had not "sustained" a "loss" within the meaning of the tax law when he sold stock at a loss to his wholly owned corporation. 308 U.S. 473, 475, 478–80 (1940). And in *Knetsch v. United States*, the Court likewise found that the taxpayer's payments to an insurance company were not "'interest paid . . . on indebtedness' within the meaning of" the tax law because the "debt" was just a sham. 364 U.S. 361, 362 (1960) (alteration in original) (citation omitted).

4. Of course, economic substance is not categorically *ir*relevant, either. As with any matter of interpretation, the ultimate question is whether the underlying tax provision itself makes economic substance relevant. *See generally* Amandeep S. Grewal, *Economic Substance and the Supreme Court*, 116 Tax Notes 969 (2007). Sometimes, as in *Gregory* and *Frank Lyon*, the relevant rule uses a malleable term or concept, like "reorganization" or "ownership." In those situations, it is appropriate for courts to consult economic substance principles when deciding "whether what was done . . . was the thing which the [rule] intended." *Gregory*, 293 U.S. at 469. In other situations, however, as in *Horn* and *Summa Holdings*, the unambiguous terms of the rule in question do not turn on the economic substance of the transaction at issue, and courts should honor compliance with the unambiguous terms of the rule.

Instead of engaging in that analysis, many lower courts, including the Fifth Circuit below, have invoked the concept of "economic substance" as a roving license "to abandon general principles of statutory construction . . . [and] recast transactions to avoid . . . result[s] inconsistent with a judge's notion of a Code section's purpose." *Mazzei v. Commissioner*, 150 T.C. 138, 197 (2018) (Holmes, J., dissenting).

This Court would not normally let judges invalidate the results that follow from the mechanical application of clear and unambiguous rules, and it should not make an exception for tax. *See Casey*, 499 U.S. at 101 ("[The statute's] language is plain and unambiguous. What the government asks is not a construction of a statute, but, in effect, an enlargement of it by the court, so that what was omitted . . . may be included within its scope. To supply omissions transcends the judicial function." (first alteration in original) (citation omitted)).

C. The Question Presented Is Important And Warrants This Court's Review

1. The proper role, and limits, of the courts when it comes to giving effect to the clear and unambiguous terms of federal law is a matter of the utmost importance. The question whether taxpayers may rely on the clear and unambiguous text of tax rules enacted by Congress and the Treasury Department is also undeniably important: Taxpayers are entitled to rely on the clear and unambiguous text of the law, *see Casey*, 499 U.S. at 101; *Perez v. Mortgage Bankers Ass'n*, 135 S. Ct. 1199, 1223–24 (2015) (Thomas, J., concurring in the judgment), yet courts have invoked the economic substance doctrine to override such provisions and impose additional taxes, penalties, and even criminal consequences, *see United States v. Daugerdas*, 837 F.3d 212, 221–22 (2d Cir. 2016), *cert. denied*, 138 S. Ct. 62 (2017); *United States v. Wexler*, 31 F.3d 117, 127 (3d Cir. 1994), *cert. denied*, 513 U.S. 1190 (1995).

2. This Court has not opined on the scope of the economic substance doctrine for decades. Since then, economic substance cases have proliferated in the lower courts—but they have not converged on any single articulable standard. Not only do courts disagree about the fundamental role and limits of the economic substance doctrine, they also vary substantially in how they apply it. As the Second Circuit has put it: The economic substance doctrine is "not a model of clarity." *United States v. Coplan*, 703 F.3d 46, 91 (2d Cir. 2012), *cert. denied*, 571 U.S. 819 (2013); *see Klamath Strategic Inv. Fund*, 568 F.3d

at 544 (recognizing different approaches in applying doctrine; citing cases). Notably, the Treasury Department itself has recognized that the doctrine "is inherently subjective" and is applied "unevenly." U.S. Dep't of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* 94 (July 1999).[12] As a result, the Department has acknowledged, "a great deal of uncertainty exists as to when and to what extent [it] appl[ies], how [it] appl[ies], and how taxpayers may rebut [it]." *Id.* This case presents a question of threshold importance in clarifying the proper scope (and limits) of the economic substance doctrine.

3. Section 7701(*o*) does not resolve that uncertainty and, indeed, just adds to the importance of this case. Enacted in 2010, the statute clarifies what the economic substance doctrine requires in circumstances *when it applies*: A transaction will be treated as having economic substance "only if . . . [it] changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and . . . the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." 26 U.S.C. § 7701(*o*)(1).

Critically, however, Section 7701(*o*) leaves open the fundamental question of when the presence or absence of such economic substance in a given transaction actually matters. Congress expressly provided that Section 7701(*o*) would apply only when the "economic substance doctrine is relevant to a transaction" as determined "in the same manner as if this subsection had never been enacted." *Id.*

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[12] Available at https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Corporate-Tax-Shelters-1999.pdf.

§ 7701(*o*)(5)(C). In other words, by its terms, Section 7701(*o*) leaves the conflict at issue untouched.[13] Only this Court can resolve that conflict, and answer the Question Presented in a way that will ensure that tax rules are applied consistently—and consistently applied—throughout the entire country.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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July 2, 2019

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[13] If anything, Section 7701(*o*) casts doubt on the existing majority rule in the lower courts. As discussed, the majority approach treats "[e]conomic substance [a]s a prerequisite to the application of any Code provision allowing deductions." *CM Holdings*, 301 F.3d at 102. By acknowledging that there are circumstances in which "economic substance" would not even be "*relevant*," 26 U.S.C. § 7701(*o*)(5)(C) (emphasis added), however, Congress indicated that economic substance is not a uniform "prerequisite" but rather a concept that matters, or not, based on the terms of the particular rule at issue.

APPENDIX

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UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

United States Court of Appeals
Fifth Circuit
FILED
April 3, 2019
Lyle W. Cayce
Clerk

No. 17-60833

KEITH A. TUCKER; LAURA B. TUCKER,
Petitioners - Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent - Appellee

Appeal from the Decision of the
United States Tax Court
T.C. No. 12307-04

766 F. App'x 132

Before HIGGINBOTHAM, GRAVES, and WILLETT, Circuit Judges.

PER CURIAM:*

Taxpayers Keith Tucker and Laura Tucker, husband and wife, claimed a $39,188,666 loss

* Pursuant to the 5TH CIR. R. 47.5, the court has determined that this opinion should not be published and is not precedent excerpt under the limited circumstances set forth in 5TH CIR. R. 47.5.4.

deduction for the 2000 tax year resulting from Mr. Tucker's execution of a "customized solution" to mitigate the Taxpayers' income tax. The customized solution (the "FX Transaction") involved highly-complex, interrelated foreign currency option investment transactions, which complied with a literal reading of the Tax Code[1] and generated millions in paper gains and losses. The Commissioner of Internal Revenue ("Commissioner") issued Taxpayers a notice of deficiency, disallowing the entire loss deduction and determining a $15,518,704 deficiency and a $6,206,488 penalty. Taxpayers challenged the deficiency and penalty in tax court. After a trial, the tax court upheld the deficiency, finding that Taxpayers were not entitled to their claimed deduction because the underlying transaction creating the deduction lacked economic substance. However, the tax court did not uphold the penalty. Taxpayers now appeal the tax court's decision on the deficiency. In this appeal, we consider: (1) whether it was appropriate for the tax court to apply the economic substance doctrine to the FX Transaction, and (2) whether the tax court applied the economic substance doctrine correctly.[2] After careful review of the record and hearing oral argument, we find that

[1] All "Tax Code," "Code," or "Section" references are to the Internal Revenue Code of 1986, as amended and in effect in 2000. All "Treasury Regulation" references are to the Treasury Regulations, as amended and in effect in 2000.

[2] The Commissioner does not appeal the Tax Court's decision on the penalty.

the economic substance doctrine was applicable to the FX Transaction, and the tax court applied the doctrine properly as set forth by circuit precedent. Accordingly, we AFFIRM the tax court's order and decision.

BACKGROUND

Mr. Tucker's transactions at issue on this appeal involved several highly-complex, interrelated foreign currency option investment transactions. Because the tax court provided a robust overview of the facts demonstrating the complexity of the tax scheme, only facts that are relevant to the disposition of this appeal follow.[3]

In 2000, Mr. Tucker, a certified public accountant with a juris doctor, was the Chief Executive Officer of Waddell & Reed Financial, Inc. ("WR"), a national mutual fund and financial services company. As a senior company executive, Mr. Tucker received tax advice and company-sponsored personal financial planning services through WR's Financial Planning Program from KPMG. When WR stock appreciated, KPMG anticipated that Mr. Tucker would exercise his WR stock options and experience a significant income increase. In August 2000, as KPMG anticipated, Mr. Tucker exercised 1,896,167 WR stock options, for which WR withheld approximately $11.4 million in federal income tax.

Sometime in 2000, KPMG advisors and Mr. Tucker discussed ways to diversify Mr. Tucker's

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[3] The facts are gleaned from the tax court's factual findings, which we do not find to be clearly erroneous, *see Estate of Duncan v. Comm'r of Internal Revenue*, 890 F.3d 192, 197 (5th Cir. 2018), and the parties' stipulation of facts.

investments and ways for Mr. Tucker to "mitigate his income tax" from exercising his stock options. In mid-December 2000, after failed attempts to enter into two separate tax benefit transactions, KPMG recommended, and Mr. Tucker accepted, the FX Transaction. KPMG characterized the FX Transaction as a "customized" tax solution to mitigate Mr. Tucker's 2000 income tax. The FX Transaction required Mr. Tucker to invest in foreign currency options in a series of transactions to take advantage of the Tax Code and to produce millions in paper gains and losses. Mr. Tucker was aware that the IRS might disallow a loss deduction from the transaction.

I. FX Transaction

The FX Transaction involved three new entities and two separate components of offsetting foreign currency options to produce the $39,188,666 tax deduction at issue in this case.

A. Relevant Entities

In late December 2000, Mr. Tucker organized three new entities, Sligo (2000), LLC ("Sligo LLC"), Sligo (2000) Company, Inc. ("Sligo"), and Epsolon, Ltd, to execute the FX Transaction. Sligo LLC was a Delaware limited liability company and Mr. Tucker was its sole member. Sligo was an S Corporation incorporated under Delaware law, and Mr. Tucker wholly-owned the company. Sligo was a U.S. shareholder of Epsolon, an Irish shelf company, and Sligo owned 99% of the shelf company from December 18, 2000 to December 31, 2000. Sligo's 99% ownership of Epsolon resulted in Epsolon initially being classified as a controlled foreign corporation ("CFC")[4] for federal tax purposes. Effective December 27, 2000, however, Epsolon elected partnership classification and was no longer considered a CFC.

Mr. Tucker contributed $2,024,700 in cash to Sligo, and Sligo contributed $1,514,700 to Epsolon.

B. Epsolon Loss Component

Mr. Tucker generated approximately $39 million in claimed tax loss through Epsolon by artfully constructing his investments to comply with a mechanical reading of the Code. As the tax court explained:

> Epsolon executed the loss component in four steps:
>
> (1) Epsolon acquired various offsetting foreign currency digital option spread positions (spread positions); (2) it disposed of the gain legs of the spread positions while Epsolon was a CFC; (3) it made a 'check-the-box' election to become a partnership for U.S. tax purposes; and (4) it disposed of the loss legs of the spread positions.

Tucker v. Comm'r of Internal Revenue, 114 T.C.M. (CCH) 326, 2017 WL 4158704, at *13 (T.C. 2017).

On December 20, 2000, Epsolon, while a CFC, purchased from and sold to Lehman Brothers eight foreign euro currency options tied to the U.S. Dollar, where each set of options created a spread. The total premium for the options Epsolon purchased was $156,041,001, and the total premium for the options that Epsolon sold was $157,500,000. The net

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[4] A CFC is any foreign corporation of which more than 50% of the vote or value is owned by U.S. shareholders.

premium payable to Epsolon for the options was $1,458,999. The potential return on the investment was based on the volatility of the USD/euro exchange rate. Mr. Tucker understood that the options had a 40% chance of profitability.

On December 21, 2000, the euro appreciated against the dollar, and Epsolon realized a net gain of $51,260,455 after disposing of four of its euro options. As a CFC, Epsolon's $51 million gain was not subject to federal income tax. *See* Sec. 881 & Sec. 882(a)(1). Epsolon then purchased from and sold to Lehman Brothers foreign deutschemark ("dem") options using most of the proceeds from the disposition of the euro options.

On December 27, 2000, Epsolon's status as a CFC effectively ended with its "check-the-box" election[5] for partnership classification. With Epsolon's entity classification change to partnership, Epsolon was treated as liquidating and distributing its assets and liabilities to Sligo. Under the "Section 367 election,"[6] Epsolon's $51 million gain as a CFC did not carry over to the partnership. Under the "30-day rule,"[7] Sligo was not required to report Epsolon's

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[5] A "check-the-box" election "allows taxpayers to choose whether an entity will be characterized as a corporation for tax purposes." *See* Treas. Reg. § 301.7701-3(g)(1)(ii).

[6] The Section 367 election "allowed taxpayers to elect to include in income either the CFC's [earnings and profits] amount or the amount of gain realized in the liquidation." *See* Treas. Reg. § 1.367(b)-3T(b)(4)(i)(A).

[7] Under the "30-day rule" a CFC's income is "taxable to a U.S. shareholder only if the U.S. shareholder owned the CFC for 30 or more days in a taxable year."

gain as taxable income because Epsolon was a CFC for only nine days.

On December 28, 2000, Epsolon, as a partnership, disposed of some of its dem and euro options, which resulted in a net loss of $39,584,511. Epsolon's loss flowed through to Sligo. Sligo, as 99% owner of Epsolon, claimed a 99% share of Epsolon's loss of $39,188,666. Sligo's reported share of the loss passed through to Mr. Tucker. *See* 26 U.S.C. § 704(d)(1) (limiting share of partnership loss to adjusted basis of partner's interest). Taxpayers reported the $39,188,666 loss as a deduction on their 2000 tax form.

C. Sligo LLC Basis Component

Taxpayers have conceded the manipulation of the Sligo Basis Component, in which Mr. Tucker inflated his basis in Sligo. However, they argue that they are entitled to a basis in Sligo of $2,024,700, which is what Mr. Tucker purportedly made to Sligo in cash contributions.

On December 21, 2000, Sligo LLC purchased from and sold to Lehman Brothers Japanese yen currency options tied to the U.S. dollar. While the premium for the purchased yen option was $51 million, the premium for the sold yen option was $50,490,000, making the net premium from Sligo LLC to Lehman Brothers $510,000.

On December 26, 2000, Mr. Tucker transferred his 100% ownership interest in Sligo LLC to Sligo. Mr. Tucker claimed a $53 million basis in Sligo, calculated as the $51 million premium paid for the yen option plus $2,024,700 in purported cash contributions, without accounting for the premium received for the yen options. The increased basis would permit Mr. Tucker to take full advantage of the Epsolon loss for tax purposes.

II. Taxpayers' 2000 Tax Return

On March 26, 2001, Taxpayers filed a joint tax return for the 2000 tax year. Taxpayers reported $44,187,744 in wages and salaries, including $41,034,873 in gain from Mr. Tucker's WR stock options, and Taxpayers reported the $39,188,666 Epsolon loss as a deduction. Taxpayers reported another $13 million in passthrough loss from Sligo on their 2001 tax return. In total, Taxpayers reported over $52 million in loss for 2000 and 2001. On April 15, 2004, the Commissioner issued Taxpayers a notice of deficiency, disallowing the entire loss deduction and determining a $15,518,704 deficiency and a $6,206,488 accuracy-related penalty.

III. The Tax Court's Decision

In tax court, Taxpayers challenged the Commissioner's disallowance and argued, *inter alia*, that Taxpayers were permitted to deduct the Epsolon loss to the extent of Mr. Tucker's basis in Sligo. The Commissioner argued, *inter alia*, that the transactions underlying the claimed loss lacked economic substance. The tax court agreed with the Commissioner, applied the economic substance doctrine to Mr. Tucker's transaction, and upheld the Commissioner's disallowance.

This appeal followed.

JURISDICTION AND STANDARD OF REVIEW

We have jurisdiction to review the tax court's final decision under 26 U.S.C. § 7482(a)(1).

We review the facts used to determine whether a transaction lacks economic substance for clear error, and we review the ultimate determination of whether a transaction lacks economic substance *de novo*. *See Estate of Duncan*, 890 F.3d at 197; *Nevada Partners Fund, L.L.C. ex rel. Sapphire II, Inc. v. U.S. ex rel. I.R.S.*, 720 F.3d 594, 610 (5th Cir. 2013), *vacated on other grounds by* 571 U.S. 1119 (2014).

DISCUSSION

I. Economic Substance Doctrine

"The economic substance doctrine allows courts to enforce the legislative purpose of the Code by preventing taxpayers from reaping tax benefits from transactions lacking in economic reality." *Klamath Strategic Inv. Fund ex rel. St. Croix Ventures v. United States*, 568 F.3d 537, 543 (5th Cir. 2009). While "taxpayers have the right to decrease or avoid taxes by legally permissible means," "transactions which do not vary control or change the flow of economic benefits are to be dismissed from consideration." *Id.* (citations omitted).

The doctrine has emerged from the Supreme Court's decision in *Gregory v. Helvering*, 293 U.S. 465 (1935). The Court reviewed a taxpayer's series of transactions to determine "whether what was done, apart from the tax motive, was the thing which the statute intended." *Id.* at 469. The Court found that the transactions fell outside the Code's plain intent, even though the transactions were technically consistent with the Code. *Id.* at 469–70.

In *Southgate*, this court applied the economic substance doctrine to determine the tax consequences of three interrelated transactions, noting that "a transaction's tax consequences depend on its substance, not its form." *Southgate Master Fund, L.L.C. ex rel. Montgomery Capital Advisors, LLC v.*

United States, 659 F.3d 466, 478–79 (5th Cir. 2011). The court noted that the economic substance doctrine, "empower[s] the federal courts to disregard the claimed tax benefits of a transaction—even a transaction that formally complies with the black-letter provisions of the Code and its implementing regulations—if the taxpayer cannot establish that 'what was done, apart from the tax motive, was the thing which the statute intended.'" *Id.* at 479 (quoting *Gregory*, 293 U.S. at 469).

The tax court applied the economic substance doctrine to the FX Transaction and determined that the transaction lacked economic substance. Taxpayers raise two issues on appeal. First, Taxpayers argue that the tax court erred in applying the economic substance doctrine. Second, Taxpayers argue, if the economic substance doctrine is applicable, the tax court did not apply the doctrine properly. We find no error in the tax court's decision.

II. The Economic Substance Doctrine is Applicable to the FX Transaction

The tax court applied the economic substance doctrine to the FX Transaction because Taxpayers "offered nothing to indicate that Congress intended to provide the tax benefits they seek through the formal application of the Code and the regulations without conforming to economic reality." *Tucker*, 2017 WL 4158704, at *17. Looking in isolation at each tax rule used to implement the FX Transaction and heavily relying on extra-circuit precedent, Taxpayers argue that the economic substance doctrine is inapplicable because the transaction complied with a literal reading of the Code.

The Supreme Court and this court have applied the economic substance doctrine to transactions that technically complied with tax laws. In *Gregory*, the Court looked beyond the form of the transaction to consider its economic substance. 293 U.S. 465. Despite the taxpayer's literal compliance with the Code, the Court concluded that:

> [t]he whole undertaking, though conducted according to the terms of [the statute], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The . . . transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

Id. at 470. In *Nevada Partners*, the taxpayers implemented a multi-step investment strategy that was technically consistent with the Code. 720 F.3d at 600. This court applied the economic substance doctrine in that case, which also involved a complex foreign currency transaction. *Id.* at 610–14.

In this matter, while the FX Transaction was consistent with the Code's language, it looked like "[t]he whole undertaking . . . was in fact an elaborate and devious" path to avoid tax consequences. *Gregory*, 293 U.S. at 470. As the tax court noted, the following resulted in the Taxpayers' $39 million tax loss deduction:

> (1) Epsolon realized an aggregate gain of $51,260,455 in 2000 when it disposed of four euro options on December 21, 2000.

(2) Epsolon did not recognize the $51,260,455 gain for U.S. tax purposes because (i) Epsolon was a foreign corporation not subject to tax under section 881 or 882[8] at the time of the gain and (ii) Sligo was not required to include its share of Epsolon's gain under section 951 because Epsolon was a CFC for less than 30 days when it elected partnership status.

(3) Epsolon and Sligo were not required to recognize gain or loss when Epsolon elected partnership status because Epsolon made an election that allowed it to recognize gain equal to Sligo's basis in its Epsolon stock and Sligo had a zero basis in its Epsolon stock. *See* sec. l.367(b)-3T(b)(4)(i)(A), Temporary Income Tax Regs., 65 Fed. Reg. 3588 (Jan. 24, 2000).

(4) After Epsolon became a U.S. partnership, it disposed of an additional four foreign currency options for a net loss of $38,483,893 and transaction costs of $1,100,618 in 2000 for a total loss of $39,584,511.

(5) Sligo was required to take into account its distributive share of Epsolon's net loss, which passed through to Mr. Tucker, as Sligo's S corporation shareholder, and the

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[8] Sec. 881 imposes a tax of 30% on foreign corporations on amounts of "fixed or determinable annual or periodical gains" income from sources within the United States. Sec. 882(a)(l) taxes foreign corporations on income "effectively connected with the conduct of a trade or business within the United States."

> loss was deductible under section 165(a) and characterized as ordinary under section 988.

Tucker, 2017 WL 4158704, at *12.

It was appropriate for the tax court to apply the economic substance doctrine to the transaction to determine whether "what was done, apart from the tax motive, was the thing which the statute intended." *Southgate*, 659 F.3d at 479 (quoting *Gregory*, 293 U.S. at 469). Accordingly, the tax court did not err in applying the economic substance doctrine to the FX Transaction.

Taxpayers rely heavily on *Summa Holdings, Inc. v. Comm'r of Internal Revenue*, 848 F.3d 779 (6th Cir. 2017), to support their position that the tax court erred in applying the economic substance doctrine to the FX Transaction. In *Summa Holdings*, the Sixth Circuit reviewed the tax court's decision denying relief to a family who sought to lower their taxes by using a domestic international sales corporation ("DISC") "to transfer money from their family- owned company to their sons' Roth Individual Retirement Accounts." *Summa Holdings*, 848 F.3d at 779. The court did not apply the economic substance doctrine to the transactions because it was "not a case where the taxpayers followed a devious path to a certain result in order to avoid the tax consequences of the straight path." 848 F.3d at 788 (quotation marks and citation omitted). The Sixth Circuit found the doctrine was inapplicable because none of the transactions "was a labeling-game sham or defied economic reality," and the tax provisions used were designed for tax-reduction purposes. *Id.* at 786. The court concluded that "[a]lthough the distinction between transactions that obscure economic reality and Code-compliant, tax-advantaged transactions may be difficult to identify in some cases, the transactions in [*Summa Holdings*] are clearly on the legitimate side of the line." *Id.* at 788.

That clarity is simply not present in Mr. Tucker's transactions. The tax court concluded that Congress "neither contemplated nor intended to encourage this type of mechanical manipulation of the rules" that permits Mr. Tucker to avoid recognizing a $51 million gain. *Tucker*, 2017 WL 4158704, at *16. The tax court found that Mr. Tucker's manipulation of the rules was contrary to Congress' intent. *See id.* (noting that S. Rept. No. 87-1881 (1962), 1962-3 C.B. 707, 785, subpart F, which includes the 30-day rule, was "designed to end tax deferral on 'tax haven' operations by U.S. controlled corporations"); *id.* (citing to the preamble to the regulation which promulgated the check-the-box election and finding that Mr. Tucker's use of the partnership election "to ignore economic reality and to separate Epsolon's gains from its losses" was inconsistent with legislative intent). The tax court concluded that Mr. Tucker's calculated manipulation of the tax code "assured that [he] would have the loss he needed to offset his WR stock option income without the need to recognize the offsetting gain on the options." *Id.*

While, "the line between disregarding a too-clever-by-half accounting trick and nullifying a Code-supported tax-minimizing transaction can be elusive," *Summa*, 848 F.3d at 787, the line is clear here. Accordingly, even under *Summa Holdings*, it was appropriate for the tax court to apply the economic substance doctrine to determine whether the transactions "defied economic reality." *Id.* at 786.

III. The FX Transaction Lacks Economic Substance

The tax court applied the economic substance doctrine to the FX Transaction and concluded that the transaction lacked economic substance. Taxpayers argue that "even if the Tax Court was correct in its decision to apply the economic substance doctrine . . . the Tax Court erred in the manner in which it applied that doctrine." Specifically, the tax court erred in disregarding the fact that the transactions had a 40% chance to earn profit and concluding that Mr. Tucker had no non-tax purpose.

When applying the economic substance doctrine, this court will respect "a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features." *Frank Lyon Co. v. United States*, 435 U.S. 561, 583–84 (1978). "In other words, the transaction must exhibit [1] objective economic reality, [2] a subjectively genuine business purpose, and [3] some motivation other than tax avoidance." *Southgate*, 659 F.3d at 480. "While 'these factors are phrased in the conjunctive, meaning that the absence of any one of them will render the transaction void for tax purposes,' there is near-total overlap between the latter two factors." *Id.* (quoting *Klamath*, 568 F.3d at 544). Prongs two and three may be read as one prong because "[t]o say that a transaction is shaped totally by tax-avoidance features is, in essence, to say that the transaction is imbued solely with tax-dependent considerations." *Id.* at 480 n.40. Accordingly, the economic substance doctrine effectively has two prongs: an objective economic prong and a subjective business purpose prong. *See id.* at 480–82.

"A notice of deficiency issued by the IRS is 'generally given a presumption of correctness, which operates to place on the taxpayer the burden of producing evidence showing that the Commissioner's determination is incorrect.'" *Nevada Partners*, 720 F.3d at 610 (quoting *Sealy Power, Ltd. v. Comm'r*, 46 F.3d 382, 387 (5th Cir. 1995)). "[W]hen the taxpayer claims a deduction, it is the taxpayer who bears the burden of proving that the transaction has economic substance." *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1355 (Fed. Cir. 2006).

The tax court concluded that the FX Transaction failed both prongs of the economic substance doctrine. Taxpayers argue that the tax court "misapplied each prong of the analysis." Because we conclude that the FX Transaction fails the objective economic prong, we affirm the tax court's decision.

In the first prong of the economic substance analysis, we must determine whether the FX Transaction lacks objective economic reality. *Klamath*, 568 F.3d at 544–45. "[T]ransactions lack objective economic reality if they 'do not vary, control, or change the flow of economic benefits.'" *Southgate*, 659 F.3d at 481 (citation and alteration omitted). "This is an objective inquiry into whether the transaction either caused real dollars to meaningfully change hands or created a realistic possibility that they would do so." *Id.* (citations omitted). "[The] inquiry must be 'conducted from the vantage point of the taxpayer at the time the transactions occurred, rather than with the benefit of hindsight.'" *Id.* (quoting *Smith v. Comm'r*, 937 F.2d 1089, 1096 (6th Cir. 1991)).

Taxpayers argue that the tax court erred in disregarding the profit potential of the FX Transaction. They argue that the FX Transaction "created the realistic probability that real dollars would change hands" because Mr. Tucker had a 40% chance to generate a net profit of $487,707 for the investments. The tax court found that the FX Transaction defied objective economic reality because the "$487,707 potential profit is de minimis as compared to the expected $20 million tax benefit" and the "$52.9 million in tax losses over two years," including the $39 million at issue. *Tucker*, 2017 WL 4158704, at *20. We agree.

"A transaction has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits." *Portland Golf Club v. Comm'r*, 497 U.S. 154, 169 n.19 (1990) (quoting *Gefen v. Comm'r*, 87 T.C. 1471, 1490 (1986)); *see Southgate*, 659 F.3d at 481 & n.43. In *Nevada Partners*, this court concluded that the district court did not err in determining that the taxpayers "failed to meet their burden of proving that the transactions giving rise to the $18 million tax loss in question had economic substance." 720 F.3d at 610. The court found that the record objectively demonstrated that the series of transactions were not designed to make a profit. *Id.* at 610–611. In fact, the transactions "serve[d] no other purpose than to provide the structure through which [the taxpayer] could enjoy the $18 million reduction to his personal 2001 tax burden." *Id.* at 611. The court also found that the series of transactions lacked profit motive where the transactions were designed to ensure "a relatively insignificant range [of profit] in comparison with the $18 million tax benefit

. . . ." *Id.* at 612–13. The court concluded that the profit "was a 'relative pittance' that did 'not appreciably affect [the] beneficial interest[.]'" *Id.* at 613 (quoting *Knetsch v. United States*, 364 U.S. 361, 366 (1960)).

Considering the parties' expert report, the tax court found that there was a low likelihood, between 16% and 40%, that the FX Transaction would be profitable because the options were "egregiously" mispriced against Mr. Tucker. The tax court concluded that:

> [T]he Epsolon loss component was not designed to make a profit, but rather arranged to produce a $52.9 million artificial loss. The scheme involved separating the gains from the losses by allocating the gains to Epsolon while it was a CFC, checking the box to become a partnership, subsequently recognizing the losses, and creating a tiered passthrough-entity structure through which to claim the artificial losses. No element of the Epsolon loss and Sligo LLC basis components had economic substance; each was orchestrated to serve no other purpose than to provide the structure through which [Taxpayers] could reduce their 2000 and 2001 tax burden.

Tucker, 2017 WL 4158704, at *23.

Looking at the FX Transaction as a whole,[9] we agree with the tax court and conclude that the

[9] *See Salty Brine I, Ltd. v. United States*, 761 F.3d 484, 495 (5th Cir. 2014) (stating that "a court must look at the transaction as a whole to determine the economic substance").

transaction failed the objective economic prong because there was no reasonable possibility of profit and there was no actual economic effect. Because "the absence of any one of [the prongs] will render the transaction void for tax purposes," we need not determine whether the FX Transaction passes the subjective business purpose prong. *Southgate*, 659 F.3d at 480.

CONCLUSION

For the foregoing reasons, we AFFIRM the tax court's decision.

UNITED STATES TAX COURT

KEITH A. TUCKER AND LAURA B. TUCKER,
Petitioners v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 12307-04. Filed September 18, 2017.

114 T.C.M. (CCH) 326

MEMORANDUM FINDINGS OF FACT
AND OPINION

GOEKE, Judge: Respondent issued a notice of deficiency disallowing petitioners' claimed loss deduction of $39,188,666 for the 2000 tax year. This adjustment resulted in a $15,518,704 deficiency and a $6,206,488 section 6662 penalty.[1] The claimed loss deduction arises from a series of offsetting foreign currency digital options that petitioner Keith A. Tucker entered into through passthrough entities. One set of offsetting foreign currency options generated the loss, and a second set of offsetting foreign currency options generated a tax basis in an S corporation through which petitioners claimed the loss deduction. Through a technical application of statutory and regulatory provisions, Mr. Tucker separated the loss and gain from the offsetting options and claimed only the loss portion as U.S. source. Before trial petitioners conceded the basis component but continue to assert the deductibility of a $2,024,700 loss for 2000 based upon their purported

[1] Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure, and all section references are to the Internal Revenue Code (Code) in effect for the year in issue.

cash basis in the S corporation. Petitioners seek to carry forward the remainder of the loss deduction to the extent of stock basis in future years.

On the basis of the concession, the issues for decision are: (1) whether petitioners are entitled to deduct a loss for 2000 on the offsetting foreign currency options. We hold that they may not because the underlying option transactions lacked economic substance; and (2) whether petitioners are liable for an accuracy-related penalty under section 6662. We hold that they are not.

FINDINGS OF FACT

I. Background

At the time the petition was timely filed, petitioners resided in Texas.[2] Mr. Tucker received a bachelor of business administration degree with a major in accounting and a minor in finance in 1967 and a juris doctor degree in 1970 from the University of Texas. Mr. Tucker was licensed as a certified public accountant (C.P.A.). He never practiced law. After his college graduation and while attending law school, Mr. Tucker worked at KPMG or its predecessor (KPMG) and became a partner in 1975. Mr. Tucker started his KPMG career preparing individual tax returns and then life insurance company returns and eventually began to provide technical advice on life insurance company tax matters. He successfully developed his life insurance tax practice and a national reputation. In 1981 Mr. Tucker became the national director of KPMG's insurance practice. In 1984 Mr. Tucker left the insurance taxation field and

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[2] The parties filed stipulations of facts with accompanying exhibits which are incorporated by this reference.

joined the investment banking firm Stephens, Inc., as a senior vice president, becoming involved in mergers, acquisitions, public and private placements, and corporate finance. In 1987 Mr. Tucker joined the private equity firm Trivest, Inc., as a partner, working on middle-market leveraged buyouts. In 1991 Mr. Tucker left Trivest to become an executive at Torchmark Corp., an insurance, financial services, and real estate holding company. In 1992 Mr. Tucker became the chief executive officer (CEO) of a Torchmark subsidiary, Waddell & Reed Financial, Inc. (Waddell & Reed), a national mutual fund and financial services company targeting middle-class individual investors and small businesses. In 1998 Torchmark spun off Waddell & Reed as a publicly traded company. Mr. Tucker remained the CEO and served as a director and the chairman of the board. Mr. Tucker remained in these positions until his forced resignation in 2005. After leaving KPMG in 1984, Mr. Tucker continued to maintain a relationship with the firm. KPMG served as his personal tax adviser and return preparer. KPMG prepared petitioners' returns for 1984 through 2000 and advised Mr. Tucker on various investment, income, and estate planning issues.

A. Executive Financial Planning Program

After Waddell & Reed went public in 1998, Waddell & Reed established a company-sponsored personal financial planning program for its senior executives (WR executive program) that provided financial, estate, and income tax planning and tax return preparation services. Part of Waddell & Reed's reasoning for adopting the WR executive program was concern with its own reputation and client relationships as affected by the ethical conduct of its executives, including tax compliance issues. Waddell & Reed also wanted to ensure that senior executives focused their attention on shareholder matters rather than their own tax and investment affairs. Upon Mr. Tucker's recommendation, Waddell & Reed engaged KPMG to manage the WR executive program. KPMG also served as Waddell & Reed's auditor. Mr. Tucker recommended a friend and former KPMG colleague, Eugene Schorr, to run the WR executive program. Bruce Wertheim, a senior manager at KPMG, assisted Mr. Schorr as a principal adviser.

Mr. Schorr has a bachelor's degree in accounting and a master's degree in taxation and is a C.P.A. and a personal financial specialist. He worked in KPMG's tax compliance group and specialized in individual tax and financial planning, gifts and estates, trust planning, and charitable contributions. Mr. Schorr worked at KPMG (or its predecessors) from 1966 until he retired in 2003, becoming a partner in 1976. During his career Mr. Schorr served as partner in charge of KPMG's New York individual tax practice and as partner in charge of its national personal financial planning practice. During 2000 and 2001 he served as partner in charge of KPMG's national financial planning corporate program. Mr. Schorr taught an undergraduate estate and gift tax course for 10 years and lectured on income tax, trust, and estate planning issues at various conferences and institutes. He wrote tax articles and served on the editorial board of Taxation for Accountants and as a director of the New York State Society of Certified Public Accountants. Throughout this career Mr. Schorr emphasized the importance of client relationships. In his experience, many senior executives lacked time to handle their own financial and estate planning and tax matters. Mr. Schorr had extensive experience in the development and administration of executive financial planning programs such as the WR executive program. Mr. Tucker considered Mr. Schorr trustworthy and knowledgeable and viewed him as the preeminent person at KPMG for coordinating tax return compliance, tax planning, estate planning, and financial planning for executives.

From 1999 through 2001 KPMG provided Waddell & Reed's senior executives, including Mr. Tucker, with individual tax and financial planning services pursuant to the WR executive program. As part of the WR executive program, KPMG asked Waddell & Reed's senior executives to complete a comprehensive information-gathering document relating to the executives' financial and tax situations and financial and nonfinancial goals. KPMG used the information to develop specific recommendations for the executives.

B. Waddell & Reed Stock Options

During his employment with Waddell & Reed, Mr. Tucker participated in an executive deferred compensation stock option plan (WR stock options plan). By 2000 Waddell & Reed's stock had significantly appreciated in the short time since it had gone public in 1998. KPMG anticipated that Waddell & Reed's executives, including Mr. Tucker, would exercise their WR stock options during 2000 to take advantage of the increased stock value and would experience significant increases in their 2000 incomes as a result of exercising the WR stock options. KPMG advised Mr. Tucker on timing and restrictions upon the exercise of the WR stock options. On August 1, 2000, Mr. Tucker exercised 1,776,654 WR stock options. On that same date he exercised 119,513 WR stock options via the Keith A. Tucker Children's Trust Agreement, dated February 21, 2000. On their 2000 joint income tax return, petitioners reported $44,187,744 in wages and salaries, which included $41,034,873 in gain from the exercise of WR stock options. Waddell & Reed withheld Federal income tax of approximately $11.4 million from Mr. Tucker's compensation relating to the exercise of the options.

II. Evolution of a Tax Strategy

In May 2000 before exercising the WR stock options, Mr. Tucker met with KPMG advisers to discuss his financial and tax planning for 2000 including his exercise of the WR stock options. They discussed the need to withhold income tax upon the exercise of the WR stock options. Mr. Schorr also explained the need for Mr. Tucker to diversify his investments. Mr. Tucker viewed his WR investments as conservative and wanted to diversify into riskier investments. Mr. Schorr advised Mr. Tucker that KPMG offered various investment programs that could mitigate his income tax resulting from exercising the WR stock options. Mr. Tucker viewed his conversations with KPMG as part of the WR executive program. KPMG had trained and directed its partners to refer clients with income over a certain threshold to KPMG's Innovative Strategies Group. Mr. Schorr identified Mr. Tucker as a potential client for the Innovative Strategies Group in the spring of 2000 on the basis of Mr. Tucker's 2000 income from his exercise of the WR stock options. Mr. Schorr conferred with Timothy Speiss, the northeast partner in charge of KPMG's Innovative Strategies Group, and with other KPMG partners with respect to Mr. Tucker. Mr. Schorr asked Mr. Speiss to meet with Mr. Tucker to discuss tax strategies to mitigate his 2000 income tax. Mr. Speiss has a bachelor's degree in business with a major in accountancy and a master of science degree in taxation. He began working at KPMG in 1983 and became a partner in 1999. At trial in this case Mr. Speiss asserted his Fifth Amendment privilege against self-incrimination when questioned by respondent's counsel. Mr. Tucker relied on Mr. Schorr's recommendation of Mr. Speiss because Mr. Tucker trusted Mr. Schorr. Mr. Tucker viewed his meeting with Mr. Speiss as part of the WR executive program. Mr. Tucker had not previously met Mr. Speiss and was not familiar with KPMG's Innovative Strategies Group, which Mr. Speiss described as offering specialized investment and tax planning advice.

By letter dated June 22, 2000, Mr. Wertheim provided Mr. Tucker with an estimate of Mr. Tucker's income from the planned August 2000 exercise of the WR stock options in anticipation of their upcoming meeting. On June 26, 2000, the KPMG advisers, Messrs. Speiss, Wertheim, and Schorr, met with Mr. Tucker, and Mr. Speiss explained that part of his work was to identify investment opportunities that also had tax benefits and to implement the tax benefits for KPMG's clients. KPMG proposed a tax strategy referred to as "short options" and explained that the strategy would mitigate petitioners' 2000 income tax from the WR stock options (short options strategy). Mr. Schorr explained that the Internal Revenue Service (IRS) could impose accuracy-related tax penalties and that taxpayers could protect themselves from penalties by relying on counsel. Mr. Tucker had previously been unfamiliar with IRS penalties.

On the same day Mr. Tucker also met with a representative of Quadra Associates who was a former KPMG colleague of Messrs. Tucker and Schorr to discuss a tax strategy for petitioners' 2000 income tax referred to as the Quadra Forts transaction. Mr. Schorr arranged this meeting. After these meetings Mr. Tucker decided to further pursue and investigate KPMG's short options strategy. Mr. Tucker declined to engage in the Quadra Forts transaction in part because it would require disposition of his WR stock, something he wanted to avoid as Waddell & Reed's CEO. KPMG sent a letter to Mr. Tucker, dated July 25, 2000, that described both tax strategies, which Mr. Tucker received during the first week of August. On August 2, 2000, Mr. Tucker spoke with representatives of KPMG and Helios Financial LLC (Helios) to discuss the mechanics of the short option strategy. After these discussions Mr. Tucker viewed the short options strategy as in a concept stage and he did not yet understand the transaction. KPMG provided an engagement letter to Mr. Tucker, dated August 10, 2000, and signed by Mr. Speiss, for services relating to the short option strategy for a fee of $600,000.

On August 11, 2000, the IRS issued Notice 2000-44, 2000-2 C.B. 255, which described the son of BOSS tax shelter and identified as a "listed" transaction the simultaneous purchase and sale of offsetting options and the subsequent transfer of the options to a partnership. As a result of the issuance of Notice 2000-44, supra, KPMG informed Mr. Tucker that the IRS had identified the short options strategy as a listed transaction and KPMG could no longer recommend that strategy. Mr. Tucker no longer wanted to engage in the short options strategy because of the potential negative impact on his personal and professional reputation, his career, and Waddell & Reed's reputation had he engaged in an abusive tax scheme. Mr. Tucker discussed these concerns with KPMG and indicated that he would not want to participate in an abusive tax scheme. As a result of KPMG's disclosure of Notice 2000-44, supra, and its recommendation against the short options strategy, Mr. Tucker believed he could trust KPMG not to advise him to invest in an abusive tax strategy. He believed KPMG was fulfilling its responsibilities under the WR executive program to prevent senior executives from entering into transactions that could create trouble with the IRS.

Mr. Tucker and KPMG began to discuss other tax mitigation strategies for Mr. Tucker's 2000 tax planning. In fall 2000 Mr. Tucker reconsidered the Quadra Forts transaction, upon KPMG's advice, and met with Quadra Associates. KPMG provided tax advice to Mr. Tucker on the Quadra Forts transaction and consulted with Quadra Associates as Mr. Tucker's adviser. Mr. Tucker decided to participate in the Quadra Forts transaction. The Quadra Forts transaction was scheduled to commence on December 18, 2000. Issues arose concerning Quadra Associates' unwillingness to share details about the transaction with KPMG, and the lack of disclosure could have prevented KPMG from being able to sign petitioners' 2000 return as return preparer. On December 12, 2000, Quadra Associates advised KPMG that financing for the Quadra Forts transaction was in jeopardy and the transaction might not close. On

December 14, 2000, Mr. Tucker was advised that the Quadra Forts transaction could not be completed because of a lack of financing. During this period, when Mr. Tucker first considered the short options strategy in June 2000 through the failure of the Quadra Forts transaction in mid-December 2000, Mr. Tucker had little direct communication with Mr. Speiss.

After the Quadra Forts transaction fell through, Mr. Speiss discussed with and sought approval from several members in KPMG's tax leadership positions to develop and propose a customized tax solution to mitigate Mr. Tucker's 2000 income tax by the end of the year. Mr. Speiss informed Mr. Schorr that he intended to propose a potential customized tax strategy to Mr. Tucker that involved foreign currency options. Mr. Schorr followed up with at least one member of KPMG's tax leadership to confirm that the tax leadership approved a customized tax solution for Mr. Tucker because of the sensitive nature of yearend tax strategies and because Mr. Schorr understood that KPMG would not pursue certain types of tax strategies for its clients after issuance of Notice 2000-44, supra.

On December 15, 2000, Mr. Speiss spoke with Mr. Tucker and recommended a transaction involving foreign currency options (FX transaction). KPMG customized and recommended the FX transaction to three Waddell & Reed senior executives, including Mr. Tucker. One of the other executives also executed the transaction. Mr. Speiss identified four entities, Helios, Diversified Group, Inc. (DGI), Alpha Consultants, LLC (Alpha), and Lehman Brothers Commercial Corp. (Lehman Brothers), a global financial services firm, that would collectively execute and manage the FX transaction. Mr. Tucker understood that Helios, DGI, and Alpha (promoter group) were investment advisers that would assist in implementing the FX transaction and that DGI had designed the FX transaction. Individuals associated with the promoter group explained the potential profit and loss associated with the FX transaction and informed Mr. Tucker that both the potential profit and loss would be capped. The promoter group told Mr. Tucker that he had a potential return of $800,000 on the FX transaction, after transaction costs and fees, and the probability that he would earn a profit was 40%. Mr. Tucker viewed an $800,000 profit over a short period as a good investment. In fact Mr. Tucker had a net economic loss on the FX transaction of approximately $695,000. Mr. Tucker knew about the tax benefits of the FX transaction; he also knew the IRS might disallow the loss deduction from the transaction.

On December 16, 2000, Mr. Speiss sent a letter to Mr. Tucker concerning the FX transaction and transmitting a profit and loss summary for the FX transaction and a summary of "review points" being considered by KPMG. The letter included an attachment titled "CFC timeline". The CFC timeline contained the following table:

Fri., Dec. 15	Purchase stock of CFC; enter into shareholder's agreement; fund CFC; acquire options.
Wed., Dec. 27	Latest date for sale of gain legs and purchase of replacement options

Thurs., Dec. 28	Latest effective date of check-the-box election
Fri., Dec. 29	Remaining positions expire or are sold
Mar. 13, 2001	Latest date for making retroactive check-the-box election
Tax return due date	Sec. 367(b) gain election
Sept. 15, 2001	Sec. 338 election

On December 18, 2000, Mr. Tucker spoke with Messrs. Schorr and Speiss by telephone about the FX transaction. Mr. Tucker decided to implement the FX transaction and signed an engagement letter, dated December 27, 2000, for KPMG to provide tax consulting services relating to the FX transaction. Mr. Tucker worked with Mr. Speiss to implement the transaction during the last two weeks of December 2000, including after Mr. Tucker left for a two-week vacation on December 19, 2000. Mr. Schorr did not participate in meetings and discussions between Messrs. Tucker and Speiss relating to the FX transaction. Mr. Tucker understood that Mr. Schorr was not involved in implementing the FX transaction.

III. Relevant Entities

Mr. Tucker implemented the FX transaction through three entities: Sligo (2000) Company, Inc. (Sligo), Sligo (2000), LLC (Sligo LLC), and Epsolon, Ltd. (Epsolon). In December 2000 Mr. Tucker incorporated Sligo under Delaware law, with Mr. Tucker owning all outstanding stock. Sligo elected S corporation status for Federal income tax purposes, effective December 18, 2000. In December 2000 Mr. Tucker also organized Sligo LLC under Delaware law pursuant to a limited liability company agreement dated December 19, 2000. From its inception until December 26, 2000, Mr. Tucker was the sole member of Sligo LLC. On December 26, 2000, Mr. Tucker transferred his ownership interest in Sligo LLC to Sligo.

Epsolon was a foreign corporation organized under the laws of the Republic of Ireland on November 6, 2000. When Epsolon was initially organized, Cumberdale Investment, Ltd. (Cumberdale), also a foreign corporation existing under the laws of the Republic of Ireland, owned all 100 shares of Epsolon's issued and outstanding stock. On December 18, 2000, Sligo purchased 99 Epsolon shares from Cumberdale for $10,000. From December 18 through 31, 2000, Sligo owned 99 shares and Cumberdale owned 1 share. Petitioners did not directly or indirectly own any interest in Cumberdale. Epsolon elected partnership classification for Federal income tax purposes effective December 27, 2000.

On December 18, 2000, Cumberdale and Sligo entered into a shareholder agreement to make capital contributions to Epsolon: Cumberdale agreed to contribute $15,300 and Sligo agreed to contribute $1,514,700 for a total contribution of $1,530,000. Mr. Tucker opened two accounts at Lehman Brothers, one on behalf of Epsolon (Epsolon account) and the other on behalf of Sligo LLC (Sligo LLC account).[3] On December 20, 2000, Mr. Tucker transferred $1,530,000 into the Epsolon account. Mr. Tucker made two transfers into the Sligo LLC account of $510,000 and $500,000 on December 20 and 28, 2000, respectively.

IV. FX Transaction

The FX transaction consisted of two components. The first component (Epsolon loss component) was structured in accordance with the CFC timeline outlined above. The second component (Sligo LLC basis component) was structured to increase the basis in an S corporation, Sligo, through which the Epsolon loss could pass through to Mr. Tucker.

a. Epsolon's Loss Component

i. December 20, 2000, Foreign Currency Transactions

On December 20, 2000, Epsolon purchased the following four foreign currency options (euro options) from Lehman Brothers tied to the U.S. dollar and the European euro (USD/euro) for a combined premium of $156,041,0

Option	Strike price	Payoff amount	Premium
Long euro call I	.9208 USD/euro	$187,637,704	$56,451,951

[3] Mr. Tucker signed new account forms with Lehman Brothers that referenced Notice 2000–44, 2002–2 C.B. 255. The reference to the notice did not raise concerns with Mr. Tucker about the validity of the FX transaction as he considered it to be boilerplate.

Option	Strike price	Payoff amount	Premium
Long euro call II	.9208 USD/euro	71,710,943	21,568,993
Long euro put I	.8914 USD/euro	187,445,332	56,451,284
Long euro put II	.8914 USD/euro	71,637,538	21,568,773

On December 20, 2000, Epsolon wrote to Lehman Brothers the following euro options for a combined premium of $157,500,000:

Option	Strike price	Payoff amount	Premium
Short euro call I	.9207 USD/euro	$189,827,513	$57,000,000
Short euro call II	.9207 USD/euro	72,434,183	21,750,000
Short euro put I	.8915 USD/euro	189,635,141	57,000,000
Short euro put II	.8915 USD/euro	72,360,777	21,750,000

The eight euro options expired on January 8, 2001. The total net premium payable by Lehman Brothers to Epsolon relative to the above eight euro options (December 20, 2000, euro options) was $1,458,999, which was posted as a credit to the Epsolon account at Lehman Brothers. In addition to the net premium, Epsolon was required to post a margin of $1,448,986.

The sum of these amounts, together with the accrued interest, was intended as collateral for the amount Epsolon could owe on the December 20, 2000, euro options if the USD/euro exchange rate was below .8914 or above .9208 at expiration.

On the basis of the euro options, Mr. Tucker's advisers determined there were three possible outcomes at expiration:[4]

1. If the USD/euro exchange rate was below .8914 USD/euro, the parties would exercise four of the euro options (long euro put I, long euro put II, short euro put I, and short euro put II), and Epsolon would owe a net $2,913,048 to Lehman Brothers, which would result in the return of the $1,458,999 credit and an additional loss of $1,454,049;
2. if the USD/euro exchange rate was above .8914 and below .9208 USD/euro, the parties would not exercise any of eight options, and Epsolon would realize a gain of $1,458,999 (the net premium credited to its account); or
3. if the USD/euro exchange rate was above .9208 USD/euro, the parties would exercise four of the euro options (long euro call I, long euro call II, short euro call I, and short euro call II), and Epsolon would owe $2,913,049 to Lehman Brothers, which would result in the return of the $1,458,999 credit and an additional loss of $1,454,050.

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[4] On brief respondent alleged three possible outcomes with slightly different amounts of potential loss or gain and used exchange rates of .8915 USD/euro and .9207 USD/euro. The difference is immaterial for our decision.

2. <u>December 21, 2000, Foreign Currency Transactions</u>

On December 21, 2000, the euro appreciated against the U.S. dollar. On December 21, 2000, Epsolon disposed of the following four December 20, 2000, euro options for a net gain of $51,260,455:

Option	Sold for	Closed out for	Gain
Long euro call I	$75,714,627	—	$19,262,676
Long euro call II	28,131,028	—	6,562,035
Short euro put I	—	$38,155,202	18,844,798
Short euro put II	—	15,159,054	6,590,946

On the same day, Epsolon purchased from Lehman Brothers the following two foreign currency options tied to the Deutschmark (DEM) and the U.S. dollar (Deutschmark options) for a combined premium of $103,918,493:

Option	Strike price	Payoff amount	Premium
Long DEM call I	2.1241 DEM/USD	$187,751,702	$75,760,627
Long DEM call II	2.1241 DEM/USD	71,779,358	28,157,866

Epsolon sold to Lehman Brothers the following two Deutschmark options for a combined premium of $53,316,100:

Option	Strike price	Payoff amount	Premium
Short DEM put I	2.1939 DEM/USD	$189,640,141	$38,156,208
Short DEM put II	2.1939 DEM/USD	72,364,777	15,159,892

Each of the Deutschmark options expired on January 8, 2001. On the basis of the four Deutschmark options, Epsolon owed a net premium to Lehman Brothers of $50,602,393. Epsolon paid the net premium in part by $50,531,399 in proceeds from the disposition of four December 20, 2000, euro options. Epsolon's acquisition of the Deutschmark options required it to pay an additional $70,994 premium and to post an additional margin of $9,006.

3. December 28, 2000, Foreign Currency Transactions

On December 28, 2000, Epsolon disposed of the following four foreign currency options for a net loss of $38,483,893:

Option	Sold for	Closed out for	Gain/loss
Long DEM call I	$124,340,670	—	$48,580,043

Option	Sold for	Closed out for	Gain/loss
Long euro put I	4,565,799	—	(51,885,485)
Short euro call I	—	$125,715,399	(68,715,399)
Short DEM put I	—	4,619,260	33,536,948

4. January 8, 2001, Foreign Currency Transactions

On January 8, 2001, the four remaining euro and Deutschmark options expired. As of January 8, 2001, Epsolon had not exercised four options, which expired as follows:

1. the long DEM option call II expired, and Lehman Brothers owed $71,779,358 to Epsolon;
2. the short euro call option II expired, and Lehman Brothers owed $72,434,183 to Epsolon;
3. the long euro put option II expired out of the money; and
4. the short DEM put option II expired out of the money.

B. Sligo LLC Basis Component

On December 21, 2000, Sligo LLC purchased from Lehman Brothers a long put option to sell 14,392,491,546 Japanese yen (yen option) at a strike price of 108.96 yen to the U.S. dollar for a $51 million premium. Also on December 21, 2000, Sligo LLC sold a yen put option to Lehman Brothers to sell 14,277,335,279 yen at a strike price of 108.97 yen to the U.S. dollar for a premium of $50,490,000. Both yen options expired on December 21, 2001, a one-year period from execution to maturity. Sligo LLC owed Lehman Brothers a net premium of $510,000 for the two yen options. If the yen/USD exchange rate was above 108.96 at expiration, Sligo LLC would receive a net payment of 115,136,267 yen (worth between $1,081,390 and $1,068,710). If the yen/USD exchange rate was below 108.96 at expiration, both yen options would expire worthless, and Sligo LLC would lose the $510,000 premium paid to Lehman Brothers.

On December 26, 2000, Mr. Tucker transferred his 100% ownership interest in Sligo LLC to Sligo. Epsolon took the reporting position that: (1) it was a controlled foreign corporation (CFC) for a period of nine days before it elected partnership classification, i.e., the taxable year ended December 26, 2000, and (2) its partnership election resulted in a deemed liquidation of Epsolon but did not result in any taxable income to Epsolon. See sec. 301.7701-3(g)(1)(ii), Proced. & Admin. Regs. In calculating Mr. Tucker's basis in his Sligo stock, petitioners increased Mr. Tucker's basis by the $51 million premium paid for the long yen put option and $2,024,700 in purported cash contributions. However, Mr. Tucker did not decrease his Sligo stock basis by the premium received for the short yen put option. Mr. Tucker claimed a basis in his Sligo stock of $53,024,700. Petitioners' basis calculation for the Sligo stock was based on the position that the obligation to fulfill the short yen put option was a "contingent" obligation which did not reduce Mr. Tucker's basis in his Sligo stock under section 358(a) and (d).

The Sligo LLC yen options created a basis component of the FX transaction similar to the basis inflation identified in Notice 2000-44, supra. Mr. Tucker was not aware that the FX transaction involved a basis component at the time he executed the FX transaction. Mr. Tucker had received but did not read written communications that referred to a basis component. Petitioners have conceded the Sligo LLC basis component but continue to argue that Mr. Tucker is entitled to a basis in his Sligo stock, as of December 31, 2000, for purported cash contributions of $2,024,700 that he had made during the 2000 tax year.[5]

V. Professional Advice on Mr. Tucker's 2000 Tax Year

KPMG represented to Mr. Tucker that the FX transaction was not covered by Notice 2000-44, supra. Mr. Tucker did not read Notice 2000-44, supra, because he did not think that he would understand it and because he trusted his KPMG advisers. Mr. Tucker understood that KPMG would not provide an opinion regarding the tax effects of the FX transaction because KPMG was Mr. Tucker's return preparer and because Mr. Speiss had planned the FX transaction. KPMG orally communicated to Mr. Tucker that the claimed tax treatment of the FX transaction was warranted. KPMG indicated that it would sign petitioners' return reporting the FX transaction,

[5] Respondent asserts that petitioners have not substantiated the capital contribution.

giving Mr. Tucker comfort that the FX transaction was a legitimate tax planning solution.

A. Brown & Wood Tax Opinions

On or around December 26, 2000, Mr. Tucker engaged the law firm Brown & Wood to provide a tax opinion with respect to the FX transaction upon KPMG's recommendation. KPMG had recommended three law firms to Mr. Tucker, and he chose Brown & Wood to provide the opinions because he was familiar with the firm. Mr. Tucker understood that he needed a legal opinion as an "insurance policy" to ensure that the tax treatment of the FX transaction was proper and to protect against risk of IRS penalties. Mr. Tucker did not understand that Brown & Wood was involved with the development of the FX transaction. Mr. Tucker had a conference call with Mr. Speiss and counsel from Brown & Wood on December 15, 2000.

In late January 2001 James Haber, president of DGI, advised R.J. Ruble, a tax partner at Brown & Wood, that Mr. Tucker would require two opinions with respect to the FX transaction: one relating to the Sligo LLC basis component (Sligo opinion) and the second relating to a loss generated by the Epsolon loss component (Epsolon opinion). DGI's general counsel had prepared a draft memorandum, dated October 25, 2000, discussing the U.S. tax consequences of a CFC strategy similar to that used in the Epsolon loss component (CFC memorandum). The CFC memorandum included the CFC timeline given to Mr. Tucker before he engaged in the FX transaction. DGI provided the CFC memorandum and also a form legal opinion relating to the Sligo LLC basis component to Mr. Ruble when he was preparing the two Brown

& Wood opinions. The two Brown & Wood opinions concluded Mr. Tucker's tax treatment of the FX transaction would more likely than not withstand IRS scrutiny and referenced multiple tax-law doctrines, including the sham transaction doctrine, economic substance, the step transaction doctrine, section 465 at-risk rules, and the basis adjustment rules.

Mr. Tucker received the Sligo opinion after filing his 2000 income tax return, having filed the return approximately three weeks before the due date in order to obtain his expected refund of the tax withheld with respect to the WR stock options. Mr. Tucker received the Epsolon opinion before he filed his 2000 return. Mr. Tucker questioned KPMG, as his tax return preparer, about the need to wait to file his 2000 return until he received both opinions. KPMG advised him that a delay in filing was not necessary because KPMG confirmed the opinions were forthcoming. Petitioners presented expert testimony that it was within acceptable practice standards at the time of the FX transaction to provide a tax opinion after the filing of a tax return. Both opinions were backdated to December 31, 2000; petitioners' expert noted no advantage to backdating an opinion, and backdating was not part of practice standards. Mr. Tucker did not read the Brown & Wood opinions, believing that he would not understand their technical nature. Mr. Tucker relied on KPMG to review the Brown & Wood opinions, consistent with his normal practice. There is no evidence in the record concerning Brown & Wood's fee for the two opinions or how the fee was paid.

B. Speiss Memorandum

Mr. Speiss prepared a 48-page single-spaced memorandum addressed to Mr. Tucker, dated January 8, 2001 (Speiss memorandum), that summarized the FX transaction and analyzed the tax consequences of the FX transaction. The Speiss memorandum states it is not a tax opinion. The memorandum described the application of the relevant Code provisions relied on for petitioners' reporting position and provided an analysis of various statutory provisions and judicial doctrines that the IRS could attempt to use to challenge or recharacterize the FX transaction, including economic substance, sham transaction, sham partnership, and step transaction doctrines, at-risk rules, and partnership antiabuse rules. The Speiss memorandum concluded that Notice 2000-44, supra, should not apply and the FX transaction should not trigger the substantial understatement penalty. Mr. Tucker understood that the purpose of the Speiss memorandum was to support KPMG's signature as tax return preparer on petitioners' 2000 return claiming the loss from the FX transaction. KPMG prepared and signed petitioners' 2000 return in accordance with the Speiss memorandum. In January 2001 Mr. Tucker received a copy of the Speiss memorandum but did not read it.

C. Schorr Memorandum

Mr. Schorr prepared an internal four-page memorandum to file (Schorr memorandum) dated January 18, 2001, that described advice and recommendations that KPMG provided to Mr. Tucker during 2000. Mr. Schorr did not expect that Mr. Tucker would read the Brown & Wood opinions. Mr.

Tucker received the Schorr memorandum before filing his 2000 return. He read the Schorr memorandum because it was a short document and because he had not requested it and was not aware that Mr. Schorr had drafted a memorandum. He described the Schorr memorandum as written in layman's terms for a client to understand. The Schorr memorandum indicated that Mr. Schorr drafted it in response to the IRS' increased scrutiny of tax solutions as announced in Notice 2000-44, supra. The Schorr memorandum memorialized KPMG internal discussions about the implementation of a tax solution for Mr. Tucker, including the short options strategy, the Quadra Forts transaction, and the FX transaction. The memorandum stated that Mr. Speiss had conferred with DGI and Brown & Wood to develop a customized tax solution for Mr. Tucker and that Mr. Speiss had developed the tax and investment structure with Helios and Brown & Wood. Despite the statements in the Schorr memorandum, Mr. Tucker did not understand that Brown & Wood had a conflict of interest that precluded its providing an independent legal opinion.

The Schorr memorandum summarized discussions with Mr. Tucker about his unwillingness to enter into a transaction that could result in IRS penalties. The memorandum indicated possible IRS penalties of $4 million as a result of the FX transaction and advice given to Mr. Tucker to make a $5 million long-term investment to hedge against penalties. Mr. Tucker invested $3 million in junk-bond, high-yield securities and $1 million in fixed-income instruments and hedging transactions. The Schorr memorandum also summarized KPMG internal discussions on fees charged to Mr. Tucker. KPMG charged Mr. Tucker a

$500,000 fee for services relating to the FX transaction, and the Schorr memorandum referred to an initial fee of $250,000. The Schorr memorandum stated that Mr. Speiss insisted on a larger fee because he had developed and implemented the FX transaction from beginning to end. The memorandum also stated that a fee based on hours of service would be between $250,000 and $300,000. Mr. Tucker also paid a $1,020,000 fee to Helios relating to the FX transaction. The relationship between Helios and DGI is unclear from the record.

Mr. Schorr knew that the IRS might disallow the claimed tax treatment of the FX transaction but believed that Mr. Tucker would not be subject to IRS penalties. This comports with Mr. Tucker's understanding of the advice he received from KPMG. Although Mr. Schorr wrote in his memorandum that Mr. Speiss developed the FX transaction with Helios and Brown & Wood, Mr. Schorr did not realize that Brown & Wood would have a conflict of interest when providing a tax opinion. Mr. Schorr did not receive copies of the Brown & Wood opinions and did not read the opinions.

VI. Tax Reporting

For 2000, Epsolon, a foreign entity, reported a $38,483,893 net loss from the December 28, 2000, disposition of the four foreign currency options plus an additional loss from transaction costs of $1,100,618 for a total loss of $39,584,511 (option loss). Epsolon allocated $39,188,666 of the option loss to Sligo on the basis of Sligo's 99% ownership. Sligo reported this option loss on its S corporation return for the period December 18 to 31, 2000. On their 2000 joint return, petitioners reported a loss of

$39,203,302, consisting, in large part, of the $39,188,666 passthrough loss from Sligo. Petitioners also reported a $13,742,247 loss from Sligo on their 2001 joint return for a total loss of over $52.9 million for the two years 2000 and 2001.[6]

VII. Subsequent Adviser Communications and Proceedings

In March 2002 Brown & Wood, then part of Sidley, Austin, Brown & Wood LLP (Sidley Austin), sent Mr. Tucker a letter informing him of the IRS' newly announced voluntary disclosure program, for taxpayers who had participated in tax shelters, that allowed taxpayers to avoid accuracy-related penalties. IRS Announcement 2002-2, 2002-1 C.B. 304. Brown & Wood recommended that Mr. Tucker consult his regular tax adviser about the voluntary disclosure program. Mr. Tucker discussed IRS Announcement 2002-2, supra, with Messrs. Schorr and Speiss, who advised Mr. Tucker not to make a voluntary disclosure about the FX transaction or to seek amnesty from IRS penalties because the FX

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[6] Epsolon was not subject to TEFRA procedures because it was a foreign partnership pursuant to sec. 6031(e) for the year in issue. For 2001 Epsolon reported a net loss of $13,890,954 relating to the January 8, 2001, expiration of the four remaining foreign currency options. Sligo, as 99% partner, reported a $13,758,878 loss from Epsolon on its 2001 S corporation return, and petitioners reported a $13,742,247 loss from Sligo on their 2001 joint return. Respondent issued a notice of deficiency to petitioners for 2001, and petitioners filed a timely petition. The Court dismissed the case for lack of jurisdiction on the basis that the notice of deficiency was invalid because of a related TEFRA partnership proceeding, which was not yet completed. The 2001 losses are at issue in a partnership-level proceeding filed in the Court of Federal Claims. That case has been stayed pending the disposition of this case.

transaction was not a tax shelter and was not subject to the voluntary disclosure program. By letter dated April 24, 2002, Mr. Speiss sent Mr. Tucker a copy of the Speiss memorandum.

As part of a promoter examination of KPMG, the IRS issued summonses to KPMG for the names of clients to whom KPMG had sold transactions covered by Notice 2000-44, supra. In August 2003 KPMG advised Mr. Tucker for the first time that the FX transaction was a tax shelter subject to Notice 2000-44, supra. In September 2003 Mr. Tucker filed a John Doe lawsuit against KPMG in U.S. District Court to enjoin the disclosure of his identity to the IRS. The Government subsequently intervened, and the District Court dismissed the John Doe suit three days before the period of limitations for petitioners' 2000 tax year expired. KPMG disclosed Mr. Tucker's identity to the IRS in response to the summons.

On April 15, 2004, respondent issued a notice of deficiency to petitioners for 2000, disallowing a $39,188,666 loss deduction and determining a deficiency of $15,518,704 and a section 6662 accuracy-related penalty of $6,206,488. Mr. Tucker disclosed receipt of the deficiency notice to Waddell & Reed's board of directors and other senior executives. In May 2005 Mr. Tucker resigned from Waddell & Reed as his tax issues began to draw more attention in the media. The board of directors had advised Mr. Tucker that if he did not resign, he would be fired.

In August 2005 KPMG entered into a deferred prosecution agreement with the Government in which it admitted that it had participated in tax shelter transactions as part of a criminal conspiracy in an attempt to defraud the United States. KPMG agreed to pay the Government $456 million in restitution, penalties, and disgorgement of fees. In May 2007 Sidley Austin entered into a settlement with the IRS in which it agreed to pay a tax shelter promoter penalty of $39.4 million.

In April 2009 Mr. Tucker filed an arbitration complaint against KPMG and Sidley Austin before the American Arbitration Association for damages resulting from alleged fraudulent conduct relating to KPMG's advice in connection with the FX transaction. Mr. Tucker alleged that KPMG had made false representations concerning the validity of the FX transaction and the risk of IRS penalties. Mr. Tucker pursued the arbitration complaint to recover for damage to his reputation and career as a result of his involvement in the FX transaction and the resulting IRS case against him and to recover damages in connection with potential IRS penalties for 2000 and 2001. Mr. Tucker learned during the arbitration that his 2000 tax reporting position with respect to the FX transaction involved a basis-inflation component. In November 2010 KPMG entered into a settlement agreement with Mr. Tucker for an amount that would have substantially compensated for Mr. Tucker's lost salary, bonuses, and equity participation due to his forced resignation from Waddell & Reed as alleged in the complaint. Sidley Austin also settled Mr. Tucker's claim for $1,050,000.

VIII. Expert Witnesses

Respondent submitted two expert reports prepared by David F. DeRosa and Thomas Murphy.[7] Dr. DeRosa's report focuses on analyzing whether each spread position was a single economic position and concludes that each spread position represented a single economic position. Dr. DeRosa explained that the options were entered into as spreads and not as individual components and should not be separated. Dr. DeRosa testified that if Epsolon and Sligo LLC had entered into each option separately, Lehman Brothers would have required them to post massive margin amounts to cover potential liabilities. The lack of such amounts indicates that the parties to the options viewed each spread as a single economic position according to Dr. DeRosa. Dr. DeRosa opined that the options were economically inseparable. Dr. DeRosa also calculated that the expected rate of return on the option transactions was negative, exclusive of fees. Dr. DeRosa also concluded that both the Epsolon and Sligo LLC options were mispriced to Mr. Tucker's disadvantage.

Petitioners submitted an expert report by H. Gifford Fong. Mr. Fong's report evaluates whether the Epsolon foreign currency option transactions were valued consistent with market prices and whether Mr. Tucker had a reasonable profit potential with respect to the Epsolon options. Mr. Fong concludes

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[7] Voir dire of Mr. Murphy at trial revealed that he had not updated his curriculum vitae with respect to certain aspects of his employment history and trials in which he had testified in the prior four years in violation of Rule 143(g)(1)(E). As a result, we did not permit Mr. Murphy to testify and did not admit his report into evidence.

that the option transactions were valued properly and that there was a reasonable prospect for profit, net of fees and expenses. Mr. Fong determined that Mr. Tucker had a 40% chance of profit on both the Epsolon options and the Sligo LLC options. Dr. DeRosa agreed with Mr. Fong's probability calculation but also explained that Mr. Tucker would have needed to profit on both sets of options to earn a profit net of fees and that the likelihood of profiting on both sets would be lower.

OPINION

Petitioners argue that they are entitled to deduct the loss on the Epsolon options to the extent of Mr. Tucker's basis in Sligo. Having conceded Sligo's basis arising from the Sligo LLC options, petitioners assert that Mr. Tucker had a $2,024,700 basis in Sligo in 2000 on the basis of alleged cash contributions. Petitioners assert that they are entitled to deduct $2,024,700 of Sligo's loss in 2000 and to carry forward the remainder of the 2000 loss to future years to the extent of Mr. Tucker's basis in Sligo and its successor corporation, Starview Enterprises, Inc. Petitioners argue that specific and detailed provisions of the Code and the regulations dictate the tax treatment of the Epsolon options, which we should respect. In support of their position, petitioners assert that the Epsolon loss component yielded the loss claimed pursuant to the following analysis:

(1) Epsolon realized an aggregate gain of $51,260,455 in 2000 when it disposed of four euro options on December 21, 2000.

(2) Epsolon did not recognize the $51,260,455 gain for U.S. tax purposes because (i) Epsolon was a foreign corporation not subject to tax under section

881 or 882[8] at the time of the gain and (ii) Sligo was not required to include its share of Epsolon's gain under section 951 because Epsolon was a CFC for less than 30 days when it elected partnership status.

(3) Epsolon and Sligo were not required to recognize gain or loss when Epsolon elected partnership status because Epsolon made an election that allowed it to recognize gain equal to Sligo's basis in its Epsolon stock and Sligo had a zero basis in its Epsolon stock. See sec. 1.367(b)-3T(b)(4)(i)(A), Temporary Income Tax Regs., 65 Fed. Reg. 3588 (Jan. 24, 2000).

(4) After Epsolon became a U.S. partnership, it disposed of an additional four foreign currency options for a net loss of $38,483,893 and transaction costs of $1,100,618 in 2000 for a total loss of $39,584,511.

(5) Sligo was required to take into account its distributive share of Epsolon's net loss, which passed through to Mr. Tucker, as Sligo's S corporation shareholder, and the loss was deductible under section 165(a) and characterized as ordinary under section 988.

Respondent asserts several arguments against petitioners' entitlement to the ordinary loss deduction. Specifically, respondent argues that we should disallow petitioners' claimed loss deduction because (i) the Epsolon options lacked economic

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[8] Sec. 881 imposes a tax of 30% on foreign corporations on amounts of "fixed or determinable annual or periodical gains" income from sources within the United States. Sec. 882(a)(1) taxes foreign corporations on income "effectively connected with the conduct of a trade or business within the United States."

substance, (ii) the Epsolon loss was not bona fide and the Epsolon options were not entered into for profit, (iii) the step transaction doctrine prevents separating the gain from the loss on the Epsolon options, (iv) the loss should be allocated to Epsolon before the partnership election while it was a CFC because the gain and loss legs of the options are a single economic position under section 988, (v) the principal purpose of Mr. Tucker's acquisition of Epsolon and Sligo stock was to evade or avoid Federal income taxes, and (vi) Mr. Tucker was not at risk for the claimed loss under section 465.

We agree with respondent that the Epsolon options lacked economic substance. A taxpayer may not deduct losses resulting from a transaction that lacks economic substance even if that transaction complies with the literal terms of the Code. See Southgate Master Fund, LLC ex rel. Montgomery Capital Advisors LLC v. United States, 659 F.3d 466, 479 (5th Cir. 2011); Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1352-1355 (Fed. Cir. 2006). Accordingly, we do not address respondent's remaining arguments.

I. Background: Code and Regulations Applicable to the FX Transaction

Petitioners argue that the Code imposes clear, mechanical provisions to determine the taxation of foreign corporations. Petitioners contend that we must give effect to the applicable Code and regulatory provisions as written because Congress "knowingly and explicitly" enacted laws to permit the tax treatment that petitioners claimed. The tax strategy at issue involved two separate components that both used offsetting foreign currency options to create a tax benefit: (1) the Epsolon loss component used offsetting foreign currency options to generate losses and (2) the Sligo LLC basis component used offsetting foreign currency options to create a basis in an S corporation through which the Epsolon losses could flow to petitioners' joint tax return. These two components were structured and executed to work in tandem in order to generate an artificial loss to offset petitioners' nearly $50 million in taxable gains in 2000 and 2001. As petitioners argue that the mechanical provisions of the Code and the regulations dictate the tax treatment of the loss on the Epsolon options, we review the tax treatment below.

A. Epsolon Loss Component

Mr. Tucker generated the claimed tax loss through Epsolon. At the time Mr. Tucker acquired ownership of Epsolon, it was a foreign corporation for U.S. tax purposes. Mr. Tucker owned 99% of Epsolon through his wholly owned S corporation, Sligo. Epsolon executed the loss component in four steps: (1) Epsolon acquired various offsetting foreign currency digital option spread positions (spread positions); (2) it disposed of the gain legs of the spread positions while Epsolon was a CFC; (3) it made a "check-the-box" election to become a partnership for U.S. tax purposes; and (4) it disposed of the loss legs of the spread positions. Petitioners argue that Epsolon's gain on the options realized while a CFC is foreign source and not recognized for U.S. tax purposes and that Epsolon's losses after it became a partnership are U.S. source and pass through to Sligo as U.S. source loss. As an S corporation, Sligo would pass its losses through to Mr. Tucker, its sole shareholder. Accordingly, Mr. Tucker claimed the Epsolon losses on his joint return.

1. Taxation of Gain From Epsolon Options to a CFC

Petitioners argue that Congress chose not to tax foreign source income of a CFC in existence for less than 30 days with no business activities other than buying and selling foreign currency options. Epsolon was a CFC for nine days. Section 882(a)(1) taxes foreign corporations engaged in a trade or business within the United States. A trade or business within the United States generally does not include trading in stocks, securities, or commodities through an agent. Sec. 864(b)(2)(A) and (B). As Epsolon's activities were limited to foreign currency option trades through an agent, it did not have a trade or business within the United States during 2000. Accordingly, Epsolon's gain was not taxable under section 882(a)(1). Furthermore, Epsolon's gain on the options was not fixed or determinable annual or periodical income taxable to foreign corporations under section 881(a)(1). Sec. 1.1441-2(b)(2)(i), Income Tax Regs. (stating that gain from the sale of property generally is not fixed or determinable annual or periodical income).

According to petitioners' mechanical application of the Code and the regulations, petitioners could be taxed on Epsolon's gain only under section 951. However, Epsolon avoided the application of the section 951 income inclusion rules. Section 951 requires a U.S. shareholder of a CFC to include in gross income its pro rata share of the CFC's subpart F income. Subpart F income would include gain on the Epsolon options. Secs. 951(a)(1), 952(a)(2), 954(c)(1)(C). The section 951 income inclusion rule applies only if the corporation is a CFC for an uninterrupted period of 30 days. Sec. 951(a)(1). Epsolon existed as a CFC for less than 30 days because it made an election to be treated as a partnership for Federal income tax purposes. Accordingly, under the mechanical application of the rules, Sligo was not required to include Epsolon's gain on the options in its income. Petitioners contend that the Epsolon gain nevertheless had U.S. tax consequences on the basis that Sligo was required to account for the gain in its earnings and profits.

2. Loss on Epsolon Options After Partnership Election

Effective December 27, 2000, Epsolon elected partnership status, becoming a partnership for Federal income tax purposes. The partnership election resulted in two events: (i) the electing entity is deemed to distribute its assets and liabilities to its shareholders in a complete liquidation and (ii) the shareholders are then deemed to contribute the same assets and liabilities to a newly formed partnership for Federal income tax purposes. Sec. 301.7701-3(g)(1)(ii), Proced. & Admin. Regs. As a result of Epsolon's partnership election, Epsolon distributed the remaining eight options to its shareholders, Sligo and Cumberdale, a foreign entity, in a complete liquidation on December 26, 2000. Sligo received a carryover basis in its share of Epsolon's assets that Sligo was deemed to receive in the deemed liquidation. See sec. 334(b)(1). Section 332(a) provides for nonrecognition treatment on a liquidating distribution from a corporation to another corporation. Section 332(b) defines the scope of the nonrecognition treatment. Section 332(b) provides that a distribution is considered to be in complete liquidation if (1) the corporate shareholder owns at least 80% of the total combined voting power and 80% of the total number of shares of all other classes of stock and (2) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the assets occurs within the taxable year. By interposing Sligo as the 99% owner of Epsolon, rather than directly owning Epsolon himself, Mr. Tucker structured the transaction to take advantage of the section 332 nonrecognition rule for corporate shareholders and avoided recognizing gain from the deemed liquidation upon Epsolon's partnership election.

Section 367(b) provides for an exception to the section 332 nonrecognition treatment that would have required Sligo as a U.S. corporate shareholder to recognize gain on the remaining eight options that were deemed distributed from Epsolon upon the partnership election. Under section 367(b) and related regulations, a domestic parent is generally required to include in income the foreign subsidiary's earnings and profits. However, petitioners were able to avoid this exception and avoid gain or loss recognition because of temporary regulations in effect at that time. The temporary regulations allowed Sligo to elect to recognize gain upon the deemed liquidation equal to either: (1) its built-in gain in its Epsolon stock or (2) Epsolon's earnings and profits attributable to Sligo. See sec. 1.367(b)-3T(b)(4)(i)(A), Temporary Income Tax Regs., supra. The election in the temporary regulations was available only for transactions that occurred between February 23, 2000, and February 23, 2001. See T.D. 8863, 2000-1

C.B. 488. At the time of Epsolon's partnership election, Sligo had no built-in gain on its Epsolon stock; Epsolon had $51,260,455 of earnings and profits. Sligo elected to recognize the built-in gain of zero upon the deemed liquidation. According to petitioners, the deemed liquidation of Epsolon did not result in taxable income to Epsolon or Sligo.

After the deemed liquidation, Sligo was deemed to contribute the eight options back to Epsolon as a newly formed partnership. See sec. 301.7701-3(g)(1)(ii), Proced. & Admin. Regs. According to petitioners, neither Epsolon nor Sligo recognized gain or loss upon Sligo's deemed contribution of the options to Epsolon. See sec. 721(a). Epsolon calculated its basis in the newly contributed options pursuant to section 723 and received a carryover basis in the options; and Sligo calculated its basis in its Epsolon partnership interest pursuant to sections 722 and 755. Petitioners calculated Sligo's adjusted basis in its Epsolon partnership interest as Sligo's basis in the long options, subtracting the liability on the short options assumed by Epsolon. See sec. 752(a). After the partnership election on December 26, 2000, Epsolon closed out four of the remaining options for a net loss of over $38 million plus over $1 million in transaction costs on December 28, 2000, and let the other four options expire, unexercised, on January 8, 2001. Epsolon characterized the net loss on the December 28, 2000, disposition of the four options as U.S. source.

Through the above application of the mechanical rules of the Code and the regulations, Mr. Tucker did not recognize the gain on the offsetting gain legs of the Epsolon options but recognized the loss on the loss legs to offset his income on his WR stock options. In this way, Epsolon separated the gain and loss legs of the Epsolon options. Petitioners argue that both the loss and the gain were bona fide, and the Code treats them differently.

B. Sligo LLC Basis Component

As outlined above, the Epsolon loss passed through to Mr. Tucker's S corporation Sligo and then to Mr. Tucker. To take advantage of the loss, he needed to have a sufficient basis in his Sligo stock. He created a stock basis through a second set of offsetting foreign currency options (Sligo LLC basis component). Petitioners have conceded that Mr. Tucker is not entitled to the basis in his Sligo stock created through the Sligo LLC options. We summarize the Sligo LLC basis component below.

1. S Corporation Basis Adjustment Rules

Pursuant to section 1366(a), S corporation shareholders take into account their pro rata shares of passthrough S corporation income, losses, deductions, or credits in calculating their tax liabilities. When an S corporation incurs losses, the S corporation shareholders can directly deduct their shares of the S corporation losses on their individual returns in accordance with the S corporation passthrough rules. However, section 1366(d)(1) limits the amount of passthrough losses and deductions that a shareholder may claim. The amount of losses cannot exceed the shareholder's adjusted basis in the S corporation stock plus the adjusted basis of any debt owed to the shareholder by the corporation. Sec. 1366(d)(1). This limitation is imposed to disallow a deduction that exceeds the shareholder's economic investment in the S corporation. Disallowed passthrough loss deductions carry forward indefinitely and may be claimed to the extent that the shareholder increases his or her stock basis in the S corporation. Sec. 1366(d)(2).

S corporation shareholders must make various adjustments to their bases in their S corporation stock. S corporation shareholders increase their bases in S corporation stock by their pro rata shares of income and by capital contributions and decrease their bases by losses and deductions passed through to the shareholders. Secs. 1012, 1367. A shareholder may increase his or her stock basis if he or she makes an economic outlay to or for the benefit of the S corporation. Underwood v. Commissioner, 63 T.C. 468, 477 (1975) aff'd, 535 F.2d 309 (5th Cir. 1976); see Goatcher v. United States, 944 F.2d 747, 751 (10th Cir. 1991); Estate of Leavitt v. Commissioner, 875 F.2d 420, 422 (4th Cir. 1989), aff'g 90 T.C. 206 (1988). An economic outlay is an actual contribution of cash or property by the shareholder to the S corporation. Estate of Leavitt v. Commissioner, 875 F.2d at 422.

2. Sligo LLC Basis Computation

To take advantage of the Epsolon losses, Mr. Tucker had to sufficiently inflate his basis in his Sligo stock. To this end, he purported to establish the necessary basis through offsetting yen options. Through Sligo LLC he bought and sold put options with premiums of $51 million and $50.49 million, respectively, and then contributed the options to Sligo by transferring his ownership in Sligo LLC to Sligo. Mr. Tucker calculated his Sligo stock basis by increasing his basis for the $51 million premium purportedly paid for the long yen option. However, he did not decrease his stock basis for the offsetting $50.49 million premium purportedly received for the short yen option on the basis that his obligation to fulfill the short yen option was a contingent liability that did not reduce his stock basis under section 358(a) and (d). Mr. Tucker also increased his stock basis by a purported cash contribution of $2,024,700. Thus, Mr. Tucker claimed a basis in Sligo stock of $53,024,700. The basis computation above would have given him a sufficient basis in his Sligo stock to claim the Epsolon passthrough losses on his individual income tax return. Petitioners have conceded the $51 million basis increase from the premium paid for the yen option and now seek to recognize Epsolon losses to the extent they can establish a basis in Sligo through cash contributions and carry over the remaining Epsolon losses to future years.

II. Mechanical Application of the Code and Application of the Economic Substance Doctrine

Petitioners argue that the Code and the regulations mandate the above treatment of the gain and loss on the Epsolon options, and accordingly they are entitled to deduct the loss from the Epsolon options to the extent of Mr. Tucker's basis in Sligo. They argue that Congress chose not to tax the gain realized on the Epsolon options while Epsolon was a CFC for less than 30 days and chose to allow the loss realized while Epsolon was a U.S. partnership. They urge the Court to give effect to the statute as written and the regulatory choices made by the Secretary. They argue that Congress purposefully taxed U.S. shareholders of CFCs only when the entities are CFCs for 30 days or more. Sec. 951(a)(1). In addition, petitioners argue that during the limited period relevant here, regulations allowed a parent company with a foreign subsidiary to elect to recognize gain equal to either (1) the parent's built-in gain in the subsidiary's stock or (2) the foreign subsidiary's earnings and profits. Sec. 1.367(b)-3T(b)(4)(i)(A), Temporary Income Tax Regs., supra. By having Epsolon in existence as a CFC for less than 30 days, filing a partnership election, and electing to recognize built-in gain once Epsolon became a U.S. partnership, petitioners suggest that Mr. Tucker used the Code provisions as Congress intended to effectively avoid recognizing a purported $51 million gain. Petitioners, however, cite no legislative, regulatory, or other authority indicating that Congress intended such a result. Rather, legislative history and congressional intent contradict petitioners' argument. The 30-day CFC rule of section 951(a) is a linchpin of the FX transaction. Section 951 taxes U.S. shareholders of a CFC currently on their pro rata shares of certain types of CFC earnings. The legislative history states that the subpart F regime, which includes the 30-day rule under section 951(a), was "designed to end tax deferral on 'tax haven' operations by U.S. controlled corporations." S. Rept. No. 87-1881 (1962), 1962-3 C.B. 707, 785; see also H.R. Rept. No. 87-1447 (1962), 1962-3 C.B. 405, 462. It is clear that Congress neither contemplated nor intended to encourage this type of mechanical manipulation of the rules when enacting these international tax provisions. The courts have rejected a mechanical or formalistic compliance with the rules of subpart F. Garlock, Inc. v. Commissioner, 58 T.C. 423 (1972), aff'd, 489 F.2d 197 (2d Cir. 1973); see Estate of Weiskopf v. Commissioner, 64 T.C. 78 (1975); Kraus v. Commissioner, 59 T.C. 681 (1973), aff'd, 490 F.2d 898 (2d Cir. 1974); Barnes Grp. Inc. v. Commissioner, T.C. Memo. 2013-109 (considering substance over form doctrine with respect to the subpart F regime). The "mere technical compliance with the statute [subpart F] is not sufficient." Kraus v. Commissioner, 59 T.C. at 692. On multiple occasions, the courts have considered both the terms and intent of the subpart F provisions and held U.S. shareholders were subject to income inclusion and tax under subpart F consistent with the substance of the transactions rather than their form.[9]

Petitioners' argument that Congress and the Secretary approved of Mr. Tucker's use of the check-the-box partnership election to allow a loss deduction also contradicts legislative history. At the time of the promulgation of the partnership check-the-box regulations, there was a concern that taxpayers might use the partnership check-the-box election, as here, in an attempt to achieve results that are inconsistent with legislative intent. The explanation of the provisions in the preamble to T.D. 8697, 1997-1 C.B. 215, 216, which promulgated the check-the-box regulations, states:

> As stated in the preamble to the proposed regulations, in light of the increased flexibility under an elective regime for the creation of organizations classified as partnerships, Treasury and the IRS will continue to monitor carefully the uses of partnerships in the

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[9] Sec. 988 does not preclude our application of the economic substance doctrine. See Stobie Creek Invs. LLC v. United States, 608 F.3d 1366 (Fed. Cir. 2010). Sec. 988 provides that foreign currency gain or loss shall be computed separately and treated as ordinary income or loss. Respondent relies on sec. 988 as an alternative argument for treating the Epsolon options as a single economic position. We do not address this argument as we find the FX transaction lacked economic substance.

> international context and will take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties.

Mr. Tucker used the partnership election to ignore economic reality and to separate Epsolon's gains from its losses—a critical step in his prearranged transaction. This manipulation of the elective regime for creating a partnership is patently inconsistent with legislative intent and is a prime example of the kind of behavior that concerned the regulators when the flexible check-the-box rules were promulgated. The offsetting Epsolon option spreads, the splitting of the gain and loss legs through the check-the-box partnership scheme, and the election under section 1.367(b)-3T(b)(4)(i)(A), Temporary Income Tax Regs., supra, assured that Mr. Tucker would have the loss he needed to offset his WR stock option income without the need to recognize the offsetting gain on the options. Petitioners lack any support for their argument that Congress intended to permit Mr. Tucker to claim tax deductions equal to more than 75 times the amount of his actual economic loss.

Petitioners cite two 50-year-old cases from the Court of Appeals for the First Circuit in support of their position that we should respect the mechanical application of the Code and the regulations used to achieve the tax-avoidance strategy in the FX transaction, Fabreeka Prods. Co. v. Commissioner, 294 F.2d 876 (1st Cir. 1961), vacating and remanding 34 T.C. 290 (1960), and Granite Tr. Co. v. United States, 238 F.2d 670 (1st Cir. 1956). In both cases, the Court of Appeals refused to apply judicial antiabuse doctrines despite the taxpayers' clear tax-avoidance motives. Both Fabreeka and Granite Tr. are readily distinguishable on their facts and with respect to the intent of the relevant Code provisions.[10]

Neither case considers the requirements of the economic substance doctrine as established by the Court of Appeals for the Fifth Circuit and discussed below. In the Fifth Circuit judicial antiabuse principles are imposed to prevent taxpayers from subverting legislative purpose by claiming tax benefits from transactions that are fictitious or lack economic reality. The Court of Appeals has stated:

> The judicial doctrines empower the federal courts to disregard the claimed tax benefits of a transaction—even a transaction that formally complies with the black-letter provisions of the

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[10] In Fabreeka Prods. Co. v. Commissioner, 294 F.2d 876 (1st Cir. 1961), vacating and remanding 34 T.C. 290 (1960), a corporation purchased bonds at a premium in part with loans, deducted the amortized bond premium as allowed by the Code, and distributed the bonds as a dividend, which the shareholders resold for substantially the same premium paid by the corporation. In effect the corporation claimed a deduction for amounts distributed as dividends. In Granite Tr. Co. v. United States, 238 F.2d 670 (1st Cir. 1956), a corporation disposed of stock in a wholly owned corporation and then liquidated, thereby avoiding nonrecognition of gain or loss upon a complete liquidation of a subsidiary by an 80% corporate shareholder. See sec. 112(b)(6), I.R.C. 1939. The cases' validity in relation to the economic substance doctrine has been questioned as both cases apply a rigid two-part test that invalidates a transaction only if it lacks economic substance and the taxpayer's sole motivation was tax avoidance. See Fid. Int'l Currency Advisor A Fund, LLC v. United States, 747 F. Supp. 2d 49 (D. Mass. 2010), aff'd, 661 F.3d 667 (1st Cir. 2011). The Court of Appeals for the Fifth Circuit uses a conjunctive three-part test for the economic substance doctrine. Klamath Strategic Inv. Fund ex rel. St. Croix Ventures v. United States, 568 F.3d 537 (5th Cir. 2009).

> Code and its implementing regulations—if the taxpayer cannot establish that "what was done, apart from the tax motive, was the thing which the statute intended."

Southgate Master Fund, 659 F.3d at 479 (fn. ref. omitted) (quoting Gregory v. Helvering, 293 U.S. 465, 469 (1935)). Petitioners have offered nothing to indicate that Congress intended to provide the tax benefits they seek through the formal application of the Code and the regulations without conforming to economic reality. Accordingly we consider the economic reality of the options at issue.

III. Economic Substance Doctrine

Taxpayers generally are free to structure their business transactions as they wish even if motivated in part by a desire to reduce taxes. Gregory v. Helvering, 293 U.S. at 469. The economic substance doctrine, however, permits a court to disregard a transaction—even one that formally complies with the Code—for Federal income tax purposes if it has no effect other than on income tax loss. See Knetsch v. United States, 364 U.S. 361 (1960); Southgate Master Fund, 659 F.3d at 479. We will respect a transaction when it constitutes a genuine, multiparty transaction, compelled by business or regulatory realities, with tax-independent considerations that are not shaped solely by tax-avoidance features. Frank Lyon Co. v. United States, 435 U.S. 561, 583-584 (1978). Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). Generally, the taxpayer has the burden of proving that the Commissioner's determinations in a notice of deficiency are incorrect. Rule 142(a); Welch

v. Helvering, 290 U.S. 111, 115 (1933). It is well settled that "an income tax deduction is a matter of legislative grace," and the taxpayer generally bears the burden of showing his entitlement to a claimed deduction. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992).

Accordingly, the burden of proving economic substance rests on the taxpayer. See Coltec Indus., Inc., 454 F.3d at 1355-1356 & n.15.

The Courts of Appeals are split as to the application of the economic substance doctrine.[11] An appeal in this case would lie to the Court of Appeals for the Fifth Circuit absent a stipulation to the contrary and, accordingly, we follow the law of that circuit. See Golsen v. Commissioner, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971). The Court

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[11] Some Courts of Appeals require that a valid transaction have either economic substance or a nontax business purpose. See, e.g., Horn v. Commissioner, 968 F.2d 1229, 1236-1238 (D.C. Cir. 1992), rev'g Fox v. Commissioner, T.C. Memo. 1988-570; Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985), aff'g in part, rev'g in part 81 T.C. 184 (1983). Other Courts of Appeals require that a valid transaction have both economic substance and a nontax business purpose. See Dow Chem. Co. v. United States, 435 F.3d 594, 599 (6th Cir. 2006); Winn-Dixie Stores, Inc. & Subs. v. Commissioner, 254 F.3d 1313, 1316 (11th Cir. 2001), aff'g 113 T.C. 254 (1999). Still other Courts of Appeals adhere to the view that a lack of economic substance is sufficient to invalidate a transaction regardless of the taxpayer's subjective motivation. See, e.g., Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1355 (Fed. Cir. 2006). And still other Courts of Appeals treat the objective and subjective prongs merely as factors to consider in determining whether a transaction has any practical economic effects beyond tax benefits. See, e.g., ACM P'ship v. Commissioner, 157 F.3d 231, 248 (3d Cir. 1998), aff'g in part, rev'g in part T.C. Memo. 1997-115.

of Appeals for the Fifth Circuit has interpreted the economic substance test as a conjunctive "multi-factor test". Klamath Strategic Inv. Fund ex rel. St. Croix Ventures v. United States, 568 F.3d 537, 544 (5th Cir. 2009). In Klamath, the Court of Appeals stated that a transaction will be respected for tax purposes only if: (1) it has economic substance compelled by business or regulatory realities; (2) it is imbued with tax-independent considerations; and (3) it is not shaped totally by tax avoidance features. Id. at 544. Thus, the transaction must exhibit an objective economic reality, a subjectively genuine business purpose, and some motivation other than tax avoidance. Southgate Master Fund, 659 F.3d at 480. Failure to meet any one of these three factors renders the transaction void for tax purposes. Klamath, 568 F.3d at 544. While Klamath phrases the economic substance doctrine as a conjunctive, three-factor test, the Court of Appeals for the Fifth Circuit has recognized that "there is near-total overlap between the latter two factors. To say that a transaction is shaped totally by tax-avoidance features is, in essence, to say that the transaction is imbued solely with tax-dependent considerations." Southgate Master Fund, 659 F.3d at 480 & n.40. The proper focus of the economic substance doctrine is the particular transaction that gave rise to the tax benefit at issue, not collateral transactions that do not produce tax benefits. Klamath, 568 F.3d at 545. For the reasons discussed below, we find that the Epsolon option transactions fail the economic substance doctrine as set forth by the Court of Appeals for the Fifth Circuit.

A. Objective Economic Inquiry

Under the objective economic inquiry of Klamath, a transaction lacks economic reality if it does not vary, control, or change the flow of economic benefits. Southgate Master Fund, 659 F.3d at 481. The objective economic inquiry asks whether the transaction affected the taxpayer's financial position in any way, i.e. whether the transaction "either caused real dollars to meaningfully change hands or created a realistic possibility that they would do so." Id. at 481 & n.41. Stated differently, the test for objective economic reality is whether there is a reasonable possibility of making a profit apart from tax benefits. Id. at 481 n.43. The inquiry is based on the vantage point of the taxpayer at the time the transactions occurred rather than with the benefit of hindsight. Id. at 481.

Petitioners argue that the Epsolon options materially changed the taxpayer's economic position. Petitioners further argue that Mr. Tucker had a reasonable possibility of making a profit. He could have earned $487,707 profit net of fees if both the Epsolon and Sligo LLC options had been profitable, which petitioners argue reflects a reasonable possibility of profit sufficient to satisfy the objective economic inquiry as articulated by the Court of Appeals for the Fifth Circuit. Petitioners contend that Mr. Tucker had a 40% probability of earning a $1,458,999 profit on the Epsolon options and a 40% probability of earning a $558,708 profit on the Sligo LLC options for a total profit of $2,017,707 and a net profit of $487,707 after payment of KPMG's and Helios' fees. Petitioners argue this amount represents a large profit because it represents a 14% return over a short period. The parties substantially agree on the amount and probability of Mr. Tucker's profit potential from the Sligo LLC and Epsolon options. At the time of the FX transaction, Mr. Tucker also understood that the Sligo LLC options and Epsolon options each had a 40% chance of profitability. Respondent notes that Mr. Tucker needed to profit on both components to realize a net profit on the total FX transaction to cover the nearly $1.5 million in fees that Mr. Tucker paid to KPMG and Helios. Respondent argues that probability that both events would occur could have been as low as 16%. Mr. Fong acknowledged that the likelihood of profit on both components was between 16% and 40%, depending upon the extent to which there was a correlation between the two events. Neither party's expert provided testimony of the appropriate correlation, however.

1. Reasonable Possibility for Profit

The possibility of making any profit is not presumptively sufficient to show a reasonable possibility of profit. The existence of "some potential for profit" is not necessarily sufficient to establish economic substance. Keeler v. Commissioner, 243 F.3d 1212, 1219 (10th Cir. 2001), aff'g T.C. Memo. 1999-18. A transaction lacks objective economic substance if it does not "appreciably affect * * * [a taxpayer's] beneficial interest except to reduce his tax." Knetsch, 364 U.S. at 366 (quoting Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957) (Hand, J., dissenting)). A de minimis economic effect is insufficient. Id. at 365-366 (finding a transaction involving leveraged annuities to be a sham because possible $1,000 cash value of annuities at maturity was "relative pittance" compared to purported value of annuities). Respondent argues that Mr. Tucker did not have a reasonable probability of profit because the potential profit of $487,707 as outlined above was not reasonable when compared with his $20 million tax savings from the FX transaction over 2000 and 2001. Petitioners argue that we should not compare profit potential with tax benefits for purposes of the economic substance doctrine and that we should independently consider Mr. Tucker's opportunity to earn a profit. We have previously compared potential profit with tax savings in assessing economic substance. Reddam v. Commissioner, 755 F.3d 1051, 1061 (9th Cir. 2014), aff'g T.C. Memo. 2012-106; Sala v. United States, 613 F.3d 1249, 1254 (10th Cir. 2010); Gerdau Macsteel, Inc. v. Commissioner, 139 T.C. 67, 174 (2012); Humboldt Shelby Holding Corp. & Subs. v. Commissioner, T.C. Memo. 2014-47, aff'd, 606 F. App'x 20 (2d Cir. 2015). Thus, when analyzing the objective economic substance of a transaction, it is appropriate to view the reasonableness of the profit potential in the light of the expected tax benefits.

The Epsolon options gave rise to $52.9 million in tax losses over two years, 2000 and 2001, with petitioners claiming a $38 million loss for 2000 and a tax benefit of over $20 million for 2000 and 2001. The $487,707 potential profit is de minimis as compared to the expected $20 million tax benefit. Petitioners' claimed tax loss has no meaningful relevance to the minimal profit potential of $487,707 from the FX transaction. This amount is insignificant when compared to petitioners' $52.9 million in ordinary losses for 2000 and 2001 from the FX transaction and when compared to petitioners' tax savings of $20 million manufactured by the FX transaction for 2000 and 2001. Petitioners' tax savings for 2000 alone were $15.5 million. By any objective measure, the FX transaction defied economic reality. See Sala v. United States, 613 F.3d at 1254 (potential to earn $550,000 profit was dwarfed by expected tax benefit of nearly $24 million); Humboldt Shelby Holding Corp. & Subs. v. Commissioner, at *16 (potential profit of $510,000 was inconsequential compared to the $25 million tax benefit generated by the digital options); Blum v. Commissioner, T.C. Memo. 2012-16, slip op. at 35 (a 19.1% chance at realizing a $600,000 profit and a 7.6% chance of realizing a $3 million profit, were de minimis when compared to losses of over $45 million), aff'd, 737 F.3d 1303 (10th Cir. 2013). Thus, it is evident that the Epsolon options, viewed objectively, offered no reasonable expectation of any appreciable net gain but rather were designed to generate artificial losses by gaming the tax code. Accordingly, the Epsolon options fail the objective prong of the economic substance analysis.

Petitioners suggest that we ascertain profitability by considering only the Epsolon options on the basis of their concession with respect to the Sligo LLC basis component. Petitioners contend that a comparison of the profit potential and the tax benefit of only the Epsolon options shows that the profits and the tax savings are sufficiently aligned to establish that the Epsolon options had economic substance. Petitioners contend that with their concession, they are entitled to a loss deduction of approximately $2 million for 2000, which results in tax savings of roughly $800,000 for 2000. However, petitioners misstate the effect of their concession as they seek to carry over the remainder of the 2000 $38 million loss to future years to the extent that they can establish Mr. Tucker's Sligo stock basis. Petitioners further argue that we should recalculate the profit potential on the Epsolon options by allocating the $1.5 million in fees paid to KPMG and Helios equally between the Epsolon and Sligo LLC components. Under this calculation, petitioners assert that Mr. Tucker would have a profit potential of $688,090 on the Epsolon options, which represents a 30% return over a 19-day period. Petitioners argue that Mr. Tucker's potential profit is "substantial" compared to the $800,000 of tax savings petitioners claim for 2000, ignoring their carryover of the 2000 loss.

In assessing the economic substance of a transaction, we consider the transaction that gave rise to the tax benefit and not collateral transactions that do not produce tax benefits. Klamath, 568 F.3d at 545. The collateral transactions in Klamath were investments made with actual capital contributions to the partnership at issue which did not provide the tax benefits at issue. Id. The court in Klamath refused to consider the profitability of these investments in its analysis of the economic substance doctrine on the basis that the tax savings arose from an inflated partnership basis and euro purchased and distributed by the partnership. Id. Southgate Master Fund also involved two transactions (acquisition of nonperforming loans and the creation of a partnership) where the Court of Appeals for the Fifth Circuit considered which transaction created the tax savings at issue. The case involved the tax treatment of losses claimed through a partnership. The partnership's acquisition of nonperforming foreign loans resulted in more than $1 billion in losses. Southgate Master Fund, 659 F.3d at 468. The court found that despite the losses, the acquisition of the loans had economic substance. The investors prepared market research and a valuation analysis before acquiring the loans, and the acquisition was within the partners' core business of acquiring distressed debt. Id. at 469-470. The court found that the losses were unforeseeable and that a reasonable possibility of profit existed for the loans. Id. at 481. For purposes of the economic substance doctrine, the Government sought to compare the profit potential from the nonperforming loans with the tax savings from the partnership structure. The court refused to make such a comparison as the court would not combine its analysis of the loan acquisition and the partnership structure. The court found that the partners would have acquired the loans even if they had not received any tax benefits. Id. at 482. In fact one partner invested in the loans without any expectation or receipt of tax benefits. Id. The court found that the partnership was a sham, however, finding that the partnership was created to generate artificial losses and tax benefits. The court recharacterized the acquisition of the nonperforming loans as a direct sale to the individual partners, compared the profit potential from the nonperforming loans and the tax benefits from a direct sale, and found the tax benefits (from real, out-of-pocket expenses) were not disproportionate to the expected profitability. Id. at 483.

Petitioners' argument that we should ignore the Sligo LLC basis component fails for two reasons. First, the theory that we should wholly disregard one abusive component merely because it was conceded to be abusive does not imbue the other equally abusive component with economic substance. To do so would contravene the core purpose of the economic substance doctrine to give effect to economic realities. Second, if we were to disregard the basis-inflation component, we would also disregard the 40% probability of earning a $558,708 profit associated with it, thus effectively wiping out any profit potential unless we agree with petitioners' reallocation of fees on a 50-50 basis. Such a reallocation of fees is not warranted as the fees related to the entire FX transaction. Mr. Tucker would have had to profit on both the Epsolon and Sligo LLC option spreads to cover the $1.5 million in fees paid to KPMG and Helios for the FX transaction. Both the Sligo LLC and Epsolon loss components were essential to achieve the mitigation of Mr. Tucker's 2000 income tax from the WR stock options. Mr. Tucker would not have executed the Epsolon options separate from the Sligo LLC options. Cf. Southgate Master Fund, 659 F.3d 466. The two components were interrelated, and Mr. Tucker depended on the Sligo LLC basis component in his decision to proceed with Epsolon loss component. See Winn-Dixie Stores, Inc. & Subs. v. Commissioner, 113 T.C. 254, 280 (1999), aff'd, 254 F.3d 1313 (11th Cir. 2001). The Court considers "the transaction in its entirety, rather than focusing only on each individual step." Reddam v. Commissioner, T.C. Memo. 2012-106, slip op. at 42, aff'd, 755 F.3d 1051 (9th Cir. 2014).

2. Actual Economic Effect

Tax losses that fail to correspond to any actual economic losses "do not constitute the type of 'bona fide' losses that are deductible" for Federal tax purposes. ACM P'ship v. Commissioner, 157 F.3d 231, 252 (3d Cir. 1998), aff'g in part, rev'g in part T.C. Memo. 1997-115. "[T]he mere presence of potential profit does not automatically impart substance where a commonsense examination of the transaction and the record * * * reflect a lack of economic substance."

John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. 1, 79 (2013) (citing Sala v. United States, 613 F.3d 1249, 1254 (10th Cir. 2010)); see Keeler v. Commissioner, 243 F.3d at 1219. Mr. Tucker experienced a net economic loss of approximately $695,000 on the FX transaction. However, this economic loss did not cause real dollars to meaningfully change hands to the extent of the claimed tax losses of $52.9 million for 2000 and 2001 or the claimed tax loss of $38 million for 2000. See Southgate Master Fund, 659 F.3d at 481. Mr. Tucker should have expected to lose money on the FX transaction; he knew there was a 60% chance that each component would result in an economic loss. Yet his potential for economic loss was severely limited, $1,488, 985 and $510,000 on the Epsolon and Sligo LLC options, respectively, when compared to his claimed tax losses. This expected loss was part of the cost of engaging in the FX transaction to achieve the desired tax savings and was not intended to change Mr. Tucker's financial position. Had the Epsolon options resulted in a profit, the claimed artificial loss would have remained for petitioners to claim on their tax return. The artificial $39 million loss for 2000 is unrelated to the $487,707 in profit potential or the actual $695,000 economic loss that Mr. Tucker sustained.

The economics of the FX transaction do not support petitioners' claim to the losses reported on their 2000 tax return. There were four possible outcomes for the two sets of option transactions:

(1) Epsolon option transactions finished in-the-money; Sligo LLC option transactions finished in-the-money;

(2) Epsolon option transactions finished in-the-money; Sligo LLC option transactions finished out-of-the-money;

(3) Epsolon option transactions finished out-of-the-money; Sligo LLC option transactions finished out-of-the-money; or

(4) Epsolon option transactions finished out-of-the-money; Sligo LLC option transactions finished in-the-money.

The parties rely on the economic analyses of their respective experts in support of their positions concerning the options' economic effect. Both experts agree that Mr. Tucker could profit only under the fourth outcome, and only to the extent of $487,707 after accounting for fees. The other three outcomes would result in an economic loss. Both experts also used the Black Scholes Merton option pricing formula, but respondent's expert, using Mr. Fong's price determinations for the individual legs of the spread positions, concluded that the options were mispriced against Mr. Tucker. Mr. Fong did not price the spreads as a whole, however. Petitioners dispute that the options were mispriced.

Mr. Fong determined, and Dr. DeRosa agreed, that there was an approximately 40% likelihood that the Epsolon option transactions would finish out-of-the-money and an approximately 40% chance that the Sligo LLC option transactions would finish in-the-money, both events were necessary for Mr. Tucker to make the$487,707 profit, and the likelihood that both events would occur would fall between 16% and 40%. Petitioners argue that we should not consider the 60% likelihood that Mr. Tucker would lose money because Mr. Tucker did not consider the FX transaction from a loss perspective. Rather he considered only that he had a 40% chance of making a profit and could earn that profit over a short period. To this end, Mr. Tucker acknowledged he knew the options were riskier than his typical investments.

Dr. DeRosa also analyzed the expected rate of return of the FX transaction and the probability-weighted sum of the four possible outcomes, and he calculated that Mr. Tucker had a negative expected rate of return on both the Epsolon and Sligo LLC option transactions, before and after accounting for fees. Dr. DeRosa determined that Mr. Tucker's expected rates of return for the Epsolon and Sligo LLC options were—54.90% and—52.39%, respectively, after accounting for fees. Dr. DeRosa explained that the expected rate of return analysis is a fundamental tool in assessing the economics of the options because it accounts for investment costs, possible payoffs, and probabilities of those payoffs. Dr. DeRosa explained that an expected rate of return is indicative of whether an option is priced correctly and the large negative expected rates of return present in this case indicate that the options were "egregiously" mispriced against Mr. Tucker. Petitioners argue that the expected rate of return analysis is not relevant to the objective test of the economic substance doctrine because such an analysis fails to address whether the options had profit potential. At times, courts have found that negative expected rates of return indicate a lack of reasonable possibility of profit while at other times courts have given little weight to such analyses. See Stobie Creek Invs., LLC v. United States, 608 F.3d 1366, 1378 (Fed. Cir. 2012); Reddam v. Commissioner, T.C. Memo. 2012-106; Blum v. Commissioner, T.C. Memo. 2012-

16; Fid. Int’l Currency Advisor A Fund, LLC v. United States, 747 F. Supp. 2d 49, 196 (D. Mass. 2010), aff’d, 661 F.3d 667 (1st Cir. 2011). The extent to which a given analysis is instructive depends heavily on the facts of the transaction in question. Significantly mispriced assets can indicate a lack of economic substance. Reddam v. Commissioner, T.C. Memo. 2012-106; Blum v. Commissioner, T.C. Memo. 2012-16.

We have found that the FX transaction lacked profit potential on the basis of a comparison of the minimal profit potential with the $52 million in tax savings over two years. Accordingly, we do not need to rely on Dr. DeRosa’s expected rate of return analysis. For the most part, both expert reports are in agreement and use the same mathematical model and inputs. The reports, however, diverge in two key respects. First, as explained above, Dr. DeRosa relies on an expected rate of return analysis, and Mr. Fong determined profit probability. Second, the experts disagree on how to interpret each options’ value. The experts agree that the stated premium of each individual option was generally within 1% of its theoretical value. That is, each option, valued independently, was traded at or near market price at the time the trades occurred. Dr. DeRosa’s rebuttal report, however, explains that the appropriate value to examine is the net premium paid or received, relative to the theoretical value of the position, to determine whether the FX transaction was fairly priced. While not determinative, a mispriced asset can contribute to the overall picture of a transaction lacking in economic substance. See Blum v. Commissioner, slip op. at 37-38. Using Mr. Fong’s valuation calculations, Dr. DeRosa compared a market-valued net premium of $2,212,125[12] for the Epsolon euro options with the net premium of $1,458,999 payable by Lehman Brothers to Epsolon. Dr. DeRosa determined that the amount payable to Epsolon was 34% less than Mr. Fong's value, or rather, Lehman Brothers underpaid Mr. Tucker by $753,126.

Between the 60% or greater likelihood that Mr. Tucker would lose money on the options, the large negative expected rate of return, and the mispricing of the options, the expert reports indicate that the Epsolon options were expected to, and did in fact, generate an economic loss. Mr. Tucker made a minimal cash outlay, had limited financial risk, and incurred an actual economic loss of roughly $695,000, which stands in stark contrast to the claimed loss of $52.9 million over two years. Viewed objectively, the Epsolon loss component was not designed to make a profit, but rather arranged to produce a $52.9 million artificial loss. The scheme involved separating the gains from the losses by allocating the gains to Epsolon while it was a CFC, checking the box to become a partnership, subsequently recognizing the losses, and creating a tiered passthrough-entity structure through which to claim the artificial losses. No element of the Epsolon loss and Sligo LLC basis components had economic substance; each was orchestrated to serve no other purpose than to provide the structure through which petitioners could reduce

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[12] Dr. DeRosa believes that Mr. Fong's calculation contains a simple mathematical error and the correct value should be $2,388,167. If that error were corrected, the difference between the market-valued net premium and the net premium payable would increase to 39%.

their 2000 and 2001 tax burden. Accordingly, because the Epsolon option transaction lacked objective economic substance, it is void for tax purposes. See Klamath, 568 F.3d at 544 (to have economic substance a transaction must satisfy three factors). Failure to satisfy the objective economic realities inquiry is sufficient to void the Epsolon options for tax purposes. For the sake of thoroughness, we will examine whether petitioners satisfy the subjective inquiries of business purpose and nontax motivation.

B. Subjective Business Purpose Inquiry

The second and third Klamath factors, while enumerated separately, overlap and derive from the same subjective inquiry of a subjectively genuine business purpose or some motivation other than tax avoidance. Southgate Master Fund, 659 F.3d at 481. Accordingly we address the two factors together. Taxpayers are not prohibited from seeking tax benefits in conjunction with seeking profits for their businesses. Id. Taxpayers who act with mixed motives of profits and tax benefits can satisfy the subjective test. Id. at 481-482. For purposes of the subjective inquiry, tax-avoidance considerations cannot be the taxpayer's sole purpose for entering into a transaction. Salty Brine I, Ltd. v. United States, 761 F.3d 484, 495 (5th Cir. 2014). That a taxpayer enters into a transaction primarily to obtain tax benefits does not necessary invalidate the transaction under the subjective inquiry. Compaq Comput. Corp. & Subs. v. Commissioner, 277 F.3d 778, 786 (5th Cir. 2001), rev'g 113 T.C. 214 (1999). However, "[t]he existence of a relatively minor business purpose will not validate a transaction if 'the business purpose is no more than a façade'." Humboldt Shelby Holding

Corp. & Subs. v. Commissioner, at *16 (quoting ASA Investerings P'ship v. Commissioner, 201 F.3d 505, 513 (D.C. 2000), aff'g T.C. Memo. 1998-305).

Respondent asserts that Mr. Tucker engaged in the FX transaction for the sole purpose of avoiding income tax that he owed upon the exercise of his WR stock options. Petitioners counter that Mr. Tucker's admitted desire for tax savings does not negate his other motivations for entering into the FX transaction—profit and diversification. Petitioners claim Mr. Tucker's primary motivation was profit. In an effort to show his profit motives petitioners characterize Mr. Tucker's investment in the FX transaction as relatively small and describe the 40% chance of profit as very substantial and the $487,707 profit potential amount as very large over a short period. On brief, petitioners analogize Mr. Tucker's tax strategy to a double bacon cheeseburger—equating the $20 million expected tax benefits to the two hamburger patties and the $487,707 profit potential to the bacon—and urge us to believe that he "bought it for the bacon." The record, however, indicates otherwise.

Mr. Tucker did not implement the options for a genuine business purpose. Rather he entered into the Epsolon options for the sole purpose of reducing his income tax. Mr. Tucker's efforts to participate in other tax strategies before ultimately engaging in the FX transaction, including the short options strategy before KPMG terminated the strategy upon the issuance of Notice 2000-44, supra, and the Quadra Forts transaction before its financing fell through, belie Mr. Tucker's claim that his motivations were anything other than tax savings. Mr. Tucker did not approach the FX transaction as a normal investment but rather approached it as a tax-avoidance strategy despite his extensive experience in the field of finance. Mr. Tucker, a former CEO of a publicly traded financial services company, attempts to portrait himself as an unsophisticated investor. For the FX transaction he relied entirely on the advice of his tax adviser, KPMG, without any review of his own into the investment potential of the Sligo LLC or Epsolon options. His interactions with KPMG cast doubt on his purported profit motivation for engaging in the FX transaction. KPMG approached Mr. Tucker in the spring of 2000 with the idea of a tax solution to mitigate the income tax from the anticipated exercise of the WR stock options. Mr. Tucker decided to pursue a short options strategy and then exercised his WR stock options on August 1, 2000. Shortly thereafter, the IRS issued Notice 2000-44, supra, and KPMG terminated its short options strategy. KPMG sought an alternative tax solution for Mr. Tucker, which also fell through in mid-December. At the 11th hour, Mr. Speiss sought approval from KPMG's tax leadership to create a customized tax solution for Mr. Tucker. Mr. Speiss sought assistance from Helios, Alpha, and DGI to orchestrate a tax solution that involved an elaborate array of steps, including newly created entities, tax elections, and the acquisition of offsetting foreign currency digital option spreads, for the sole purpose of generating a multimillion-dollar ordinary loss in the final two weeks of the tax year. KPMG arranged the FX transaction to ensure the amount of the generated tax losses would be sufficient to offset Mr. Tucker's income from the WR stock options. They completed the transaction in a short time during the final two weeks of the tax year for the purpose of avoiding taxes owed for that year, after two other failed attempts at tax-avoidance transactions.

Mr. Tucker's testimony attempts to put a positive spin on the economic realities of the transaction, testifying that he knew that the FX transaction was riskier than his typical investments and that he sought to diversify into riskier investments. In actuality, Mr. Tucker should have expected the investment to be a failure, as he knew that the Epsolon and Sligo LLC option transactions each had a 60% chance of losing money. Mr. Tucker claims a diversification motive and made other investments of less than $5 million at the time of the FX transaction per KPMG's advice in an attempt to show his nontax profit motives. However, the record shows that the purpose of those investments was to protect against IRS penalties and not to diversify. Mr. Tucker's additional investments do not imbue the FX transaction with tax-independent considerations. Moreover, the Epsolon entity served no business purpose other than tax avoidance. At the time he acquired Epsolon, Mr. Tucker did not intend to conduct any legitimate business or investment activities through Epsolon. Epsolon was a shelf corporation established by tax shelter promoters.

Mr. Tucker's decision to enter into the FX transaction was solely tax motivated and did not have a genuine business purpose. Regardless of his purported desire for profit and diversification, Mr. Tucker executed a transaction that was structured for tax savings and not to make a profit. We note that even had petitioners established a nontax or genuine business purpose for the Epsolon options, such motivation would not have been sufficient to satisfy the conjunctive factor test for economic substance as set forth by the Court of Appeals for the Fifth Circuit. The Epsolon options lacked any practical objective economic effect.

IV. Accuracy-Related Penalties

Section 6662 provides that a taxpayer may be liable for a 20% penalty on the portion of an underpayment of tax attributable to (1) a substantial understatement of income tax, (2) negligence or disregard of rules or regulations, or (3) any substantial valuation misstatement. Sec. 6662(a) and (b)(1), (2), and (3). A "substantial valuation misstatement" occurs if the value of any property or the adjusted basis of any property claimed on an income tax return is 200% or more of the correct amount. Sec. 6662(e)(1)(A); sec. 1.6662-5(e)(1), Income Tax Regs. If the valuation misstatement is 400% or more of the correct amount, the misstatement is considered a gross valuation misstatement, and the 20% penalty increases to 40%. Sec. 6662(h). The section 6662 penalties do not apply if taxpayers demonstrate they acted with reasonable cause and in good faith. Sec. 6664(c)(1). In the deficiency notice, respondent determined in the alternative that petitioners are liable for the 20% and 40% accuracy-related penalties for negligence, a substantial understatement of income tax, a substantial valuation misstatement, or a gross valuation misstatement. There is no stacking of penalties. Sec. 1.6662-2(c), Income Tax Regs. While more than one basis for the section 6662 penalty may exist, the maximum allowed penalty is 40%. Id.

The 40% gross valuation misstatement penalty would apply in this case on the basis of petitioners' claimed inflated basis in the Sligo stock. Sec.

6662(h)(2)(A). To allow for the Epsolon option losses to pass through Sligo to petitioners' 2000 tax return, Mr. Tucker had to establish a sufficient basis in his Sligo stock, which he did through a basis-inflation transaction using offsetting option positions in the Sligo LLC basis component which petitioners have since conceded. Mr. Tucker bought and sold yen put options through Sligo LLC with gross premiums of $51 million and $50,490,000, respectively, and then contributed these positions to Sligo by transferring his Sligo LLC ownership to Sligo. Mr. Tucker paid a net premium of only $510,000 on the yen options but claimed a stock basis of $51 million, the gross premium of the purchased yen put option. Mr. Tucker did not reduce his Sligo basis by the premium received for the sold yen put option, arguing that the sold yen put option was a contingent liability that did not reduce S corporation basis under section 358(a) and (d). Petitioners have conceded this issue and now maintain that Mr. Tucker's basis is limited to cash contributions he made to Sligo during 2000. Petitioners allege that amount to be $2,024,700. Even if we assume that Mr. Tucker had a basis in Sligo equal to $2,024,700, his reported basis of $51 million exceeded that amount by more than 2,500%, far in excess of the 400% threshold required for the gross valuation misstatement penalty to apply.

Petitioners argue that they are not liable for the accuracy-related penalty because they acted with reasonable cause and in good faith in reporting their 2000 tax liability. We determine whether a taxpayer acted with reasonable cause and in good faith on a case-by-case basis, taking into account all pertinent facts and circumstances. Sec. 1.6664-4(b)(1), Income Tax Regs. A taxpayer's reliance on the advice of an independent professional may constitute reasonable cause and good faith. The advice must be based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances and must not be based on any unreasonable factual or legal assumptions. Id. para. (c)(1). We have summarized the requirements for the reasonable reliance on professional advice as: (1) the professional is a competent tax adviser with sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment. Neonatology Assocs., P.A. v. Commissioner, 115 T.C. 43, 98-99 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002). A taxpayer's education and business experience are relevant to the determination of whether the taxpayer acted with reasonable reliance on an adviser and in good faith. Sec. 1.6664-4(b)(1), Income Tax Regs. The Supreme Court recognized in United States v. Boyle, 469 U.S. 241, 251 (1985), that a taxpayer exercises "[o]rdinary business care and prudence" when he reasonably relies on a professional's advice on matters beyond the taxpayer's understanding.

A taxpayer need not challenge an independent and qualified adviser, seek a second opinion, or monitor advice on the provisions of the Code. Id. As the Supreme Court noted in Boyle: "Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney * * * would nullify the very purpose of seeking the advice of a presumed expert in the first place." Id. Advice need not be written and includes any communication that provides advice on which the taxpayer relied directly or indirectly. Sec. 1.6664-4(c)(2), Income Tax Regs. The most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Id. para. (b). The focus of the reasonable cause defense is on the taxpayer's knowledge, not the adviser's knowledge. Southgate Master Fund, 659 F.3d at 494.

The reasonableness of any reliance depends on the quality and objectivity of the advice. Klamath, 568 F.3d at 548. Reliance on an adviser is not reasonable or in good faith when the taxpayer knew or should have known that the adviser had an inherent conflict of interest. See Chamberlain v. Commissioner, 66 F.3d 729, 732-733 (5th Cir. 1995), aff'g in part, rev'g in part T.C. Memo. 1994-228; Paschall v. Commissioner, 137 T.C. 8, 22 (2011); Neonatology Assocs., P.A. v. Commissioner, 115 T.C. at 98. Taxpayers cannot in good faith rely on the advice of a promoter of a tax shelter transaction. However, the definition of a promoter is not clear from case law. We have stated that a promoter is someone who participated in the structuring of the tax shelter transaction offered to numerous clients or otherwise has a financial interest or profits from the transaction. 106 Ltd. v. Commissioner, 136 T.C. 67, 80 (2011), aff'd, 684 F.3d 84 (D.C. Cir. 2012); Tigers Eye Trading, LLC v. Commissioner, T.C. Memo. 2009-121. An adviser is not a promoter when he has a long-term and continual relationship with the client-taxpayer, does not give unsolicited advice regarding the tax shelter, advises the client only within his field of expertise and not because of his regular involvement in the tax shelter transactions, follows his regular course of conduct in rendering his advice, and has no stake in the transaction besides his regular hourly rate. 106 Ltd. v. Commissioner, 136 T.C. at 80 (citing Countryside Ltd. P'ship v. Commissioner, 132 T.C. 347, 352-355 (2009)). There is no bright-line test for determining whether an adviser is a promoter. See Am. Boat Co. v. United States, 583 F.3d 471, 483 (7th Cir. 2009). We must also consider a taxpayer's right to structure his affairs in a way that minimizes tax and to seek tax advice to accomplish that result. The reasonable cause defense does not require the taxpayer to correctly anticipate the legal consequences that the Court will attach to the underlying facts of the transaction. Southgate Master Fund, 659 F.3d at 494.

We find that Mr. Tucker is not liable for the section 6662 penalty on the basis of his reliance on Mr. Schorr of KPMG. Mr. Tucker had a long-term relationship with both KPMG and Mr. Schorr, whom he viewed as a friend. Mr. Schorr introduced and recommended Mr. Speiss. KPMG had prepared petitioners' returns for 15 years without audit. Mr. Tucker had recommended Mr. Schorr to manage the WR executive program when it was created. Mr. Tucker did not solicit or initiate the contemplation of a tax strategy. Mr. Tucker believed that KPMG was offering its services as part of the WR executive program, which Waddell & Reed established to ensure that Waddell & Reed's executives were in compliance with tax law. Mr. Tucker had informed KPMG that he did not want to engage in a transaction that would subject him to IRS scrutiny because of concern for his professional reputation and career and the potential impact on Waddell & Reed's reputation as its CEO. After the issuance of Notice 2000-44, supra, Mr. Tucker was adamantly against participating in such a transaction. KPMG repeatedly assured Mr. Tucker that Notice 2000-44, supra, did not apply to the FX transaction. Mr. Tucker believed that KPMG would protect his interests as KPMG had done when it terminated the short options strategy in response to Notice 2000-44, supra. Mr. Tucker believed that KPMG would not recommend an abusive tax shelter, and KPMG's withdrawal of the short options strategy after the issuance of Notice 2000-44, supra, confirmed this. He testified that KPMG's withdrawal of the short options strategy "made me feel better." Accordingly, when KPMG recommended the FX transaction, Mr. Tucker believed it was a legitimate tax planning solution. Because of his past experiences, Mr. Tucker did not expect that KPMG would recommend an abusive tax shelter. KPMG offered the FX transaction to only a limited number of individuals, three Waddell & Reed executives including Mr. Tucker. Mr. Tucker viewed KPMG's actions with respect to the FX transaction as an integral part of KPMG's normal tax planning advice on the basis of his longstanding relationship with KPMG, KPMG's role in the WR executive program, and his representations to KPMG that he did not want to engage in a tax strategy that could jeopardize Waddell & Reed's or his own reputation within the financial services industry. In fact, Waddell & Reed engaged KPMG to assist its senior executives in financial and tax planning in part to protect Waddell & Reed's reputation in the financial services industry. At KPMG's recommendation, Mr. Tucker made $4 million in investments separate from the FX transaction to protect himself from IRS penalties.

At the time of the FX transaction KPMG was one of the largest accounting firms in the United States.

Mr. Tucker viewed Mr. Schorr as a preeminent person for coordinating tax return compliance and tax and financial planning. Mr. Tucker believes KPMG misled him. He was forced to resign as CEO of Waddell & Reed and is no longer employable in the financial services industry. In the end, Mr. Tucker lost his position at Waddell & Reed because of his participation in the FX transaction and received a large settlement from KPMG for his lost future compensation. We note that in our order dated August 24, 2015, we found that Mr. Tucker's representations in his arbitration proceeding against KPMG support his assertion that he relied on the advice he received from KPMG in good faith. Because of Mr. Tucker's long relationship with Mr. Schorr, he was less likely to question KPMG's advice. While Mr. Tucker was motivated to reduce his 2000 income tax liability, he consistently represented to KPMG that he did not want to put his own reputation or career on the line as a result of a tax scheme. When KPMG recommended the FX transaction, Mr. Tucker believed in good faith that it was not abusive. Accordingly, we find that the section 6662 penalty is not applicable.

Mr. Schorr was a competent tax professional and had access to all necessary and accurate information about the FX transaction through his employment with KPMG. Mr. Schorr did not have a financial interest in the FX transaction as a tax shelter promoter would. While KPMG increased its fee above its initial fee, Mr. Schorr did not financially benefit from the increase. Mr. Tucker knew that Mr. Speiss at KPMG created the FX transaction as a customized tax solution to mitigate his 2000 income tax. Yet he did not understand that Mr. Speiss' involvement created an inherent conflict of interest with his longstanding relationship with Mr. Schorr and KPMG as his return preparer. Mr. Schorr also credibly testified that he did not believe Mr. Speiss' involvement created a conflict of interest. Further KPMG indicated to Mr. Tucker that Brown & Wood could provide independent legal advice with respect to the FX transaction. Mr. Tucker did not view KPMG as the promoter of a tax shelter for a number of reasons including his longstanding relationship with KPMG, KPMG's role in the WR executive program, and his statements to KPMG that he did not want to engage in a tax strategy that could jeopardize Waddell & Reed's or his own reputation within the financial services industry. He considered his main contact at KPMG, Mr. Schorr, to be a friend who would look out for his best interests. Mr. Tucker believed that KPMG would protect his interests as it had done when it terminated the short options strategy. KPMG withdrew the short options strategy as abusive, and Mr. Tucker believed that KPMG would not recommend another potentially abusive transaction. Mr. Tucker credibly testified that KPMG's withdrawal of the short options strategy strengthened his trust in KPMG and his decades-old relationship with Mr. Schorr.

We place little weight on Mr. Tucker's failure to review certain documents relating to the FX transaction. As a senior executive, Mr. Tucker depended heavily on his personal assistant. We do not view Mr. Tucker's following his normal practices when dealing with his taxes as a failure of good faith or reasonable diligence. As a senior executive, Mr. Tucker had a management style of delegating to people whom he trusted. Having his administrative assistant open and read emails relating to the FX transaction was consistent with Mr. Tucker's normal business practice. Likewise we do not find the fact that Mr. Tucker did not read Notice 2000-44, supra, himself to preclude a finding of reasonable reliance on his adviser. Respondent argues that Mr. Tucker should have read Notice 2000-44, supra.[13] Mr. Tucker, who had experience with insurance tax matters in the early part of his career, left the tax field in 1984 and focused entirely on the financial services industry. Mr. Tucker relied on KPMG because he believed that he would not understand the technical tax implications of the FX transaction. Despite his background, C.P.A. license, and law degree, Mr. Tucker had little understanding of the complicated tax issues involved in the FX transaction.

We do not base our finding of Mr. Tucker's reasonable cause and good faith on the Brown & Wood opinions. Mr. Tucker did not receive at least one of the Brown & Wood opinions before petitioners filed their 2000 joint return, did not read either opinion, and had limited direct communication with Brown & Wood attorneys. There is no evidence that Mr. Tucker directly paid any fees to Brown & Wood for the opinions. Moreover, the promoter group provided drafts of the opinions to Brown & Wood. The reasonable cause defense depends on the particular facts and circumstances of each case. In this case, we find that petitioners have established that they met the requirements of the reasonable cause defense and find that they are not liable for the section 6662

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[13] Lehman Brothers' new account forms, which Mr. Tucker did not read, also mentioned Notice 2000-44, 2000-2 C.B. 255.

penalty.[14] Mr. Tucker made a sufficient good-faith effort to assess his 2000 income tax and reasonably relied on Mr. Schorr's professional advice. To find otherwise would require taxpayers to challenge their attorneys, seek second opinions, or try to independently monitor their advisers on the complex provisions of the Code.

In reaching our holdings herein, we have considered all arguments made, and to the extent not mentioned, we conclude they are moot, irrelevant, or without merit.

To reflect the foregoing,

Decision will be entered for respondent on the deficiency and for petitioners on the penalty.

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[14] Respondent argues that Mr. Tucker's statements in the arbitration proceeding against KPMG are admissions that prevent him from establishing reasonable cause here. We disagree, as we held in our order dated August 24, 2015, denying respondent's motion for summary judgment.

26 U.S.C. § 951 (2000)

Title 26. Internal Revenue Code
Subtitle A. Income Taxes
Chapter 1. Normal Taxes and Surtaxes
Subchapter N. Tax Based on Income from Sources Within or Without the United States
Part III. Income from Sources Without the United States
Subpart F. Controlled Foreign Corporations

§ 951. Amounts included in gross income of United States shareholders

(a) Amounts included

(1) In general

If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends—

(A) the sum of—

(i) his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year,

(ii) his pro rata share (determined under section 955(a)(3) as in effect before the enactment of the Tax Reduction Act of 1975) of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such year, and

(iii) his pro rata share (determined under section 955(a)(3)) of the corporation's previously excluded subpart F income withdrawn from foreign base company shipping operations for such year; and

(B) the amount determined under section 956 with respect to such shareholder for such year (but only to the extent not excluded from gross income under section 959(a)(2)).

(2) Pro rata share of subpart F income

The pro rata share referred to in paragraph (1)(A)(i) in the case of any United States shareholder is the amount—

(A) which would have been distributed with respect to the stock which such shareholder owns (within the meaning of section 958(a)) in such corporation if on the last day, in its taxable year, on which the corporation is a controlled foreign corporation it had distributed pro rata to its shareholders an amount (i) which bears the same ratio to its subpart F income for the taxable year, as (ii) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year, reduced by

(B) the amount of distributions received by any other person during such year as a dividend with respect to such stock, but only to the extent of the dividend which would have been received if the distribution by the corporation had been the amount (i) which bears the same ratio to the subpart F income of such corporation for the taxable year, as (ii) the part of such year during which such shareholder did not own (within the meaning of section 958(a)) such stock bears to the entire year.

For purposes of subparagraph (B), any gain included in the gross income of any person as a dividend under section 1248 shall be treated as a distribution received by such person with respect to the stock involved.

(3) Limitation on pro rata share of previously excluded subpart F income withdrawn from investment

For purposes of paragraph (1)(A)(iii), the pro rata share of any United States shareholder of the previously excluded subpart F income of a controlled foreign corporation withdrawn from investment in foreign base company shipping operations shall not exceed an amount—

(A) which bears the same ratio to his pro rata share of such income withdrawn (as determined under section 955(a)(3)) for the taxable year, as

(B) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year.

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26 C.F.R. § 301.7701-3 (2000)

§ 301.7701–3 Classification of certain business entities

* * *

(c) *Elections*—(1) *Time and place for filing*—(i) *In general*. Except as provided in paragraphs (c)(1)(iv) and (v) of this section, an eligible entity may elect to be classified other than as provided under paragraph (b) of this section, or to change its classification, by filing Form 8832, Entity Classification Election, with the service center designated on Form 8832. An election will not be accepted unless all of the information required by the form and instructions, including the taxpayer identifying number of the entity, is provided on Form 8832. See § 301.6109–1 for rules on applying for and displaying Employer Identification Numbers.

(ii) *Further notification of elections*. An eligible entity required to file a federal tax or information return for the taxable year for which an election is made under paragraph (c)(1)(i) of this section must attach a copy of its Form 8832 to its federal tax or information return for that year. If the entity is not required to file a return for that year, a copy of its Form 8832 must be attached to the federal income tax or information return of any direct or indirect owner of the entity for the taxable year of the owner that includes the date on which the election was effective. An indirect owner of the entity does not have to attach a copy of the Form 8832 to its return if an entity in which it has an interest is already filing a copy of the Form 8832 with its return. If an entity, or one of its direct or indirect owners, fails to attach a copy of a

Form 8832 to its return as directed in this section, an otherwise valid election under paragraph (c)(1)(i) of this section will not be invalidated, but the non-filing party may be subject to penalties, including any applicable penalties if the federal tax or information returns are inconsistent with the entity's election under paragraph (c)(1)(i) of this section.

(iii) *Effective date of election.* An election made under paragraph (c)(1)(i) of this section will be effective on the date specified by the entity on Form 8832 or on the date filed if no such date is specified on the election form. The effective date specified on Form 8832 can not be more than 75 days prior to the date on which the election is filed and can not be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 75 days prior to the date on which the election is filed, it will be effective 75 days prior to the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election is filed, it will be effective 12 months after the date it was filed. If an election specifies an effective date before January 1, 1997, it will be effective as of January 1, 1997. If a purchasing corporation makes an election under section 338 regarding an acquired subsidiary, an election under paragraph (c)(1)(i) of this section for the acquired subsidiary can be effective no earlier than the day after the acquisition date (within the meaning of section 338(h)(2)).

(iv) *Limitation.* If an eligible entity makes an election under paragraph (c)(1)(i) of this section to change its classification (other than an election made by an existing entity to change its classification as of the effective date of this section), the entity cannot change its classification by election again during the sixty months succeeding the effective date of the election. However, the Commissioner may permit the entity to change its classification by election within the sixty months if more than fifty percent of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election. An election by a newly formed eligible entity that is effective on the date of formation is not considered a change for purposes of this paragraph (c)(1)(iv).

(v) *Deemed elections*—(A) *Exempt organizations*. An eligible entity that has been determined to be, or claims to be, exempt from taxation under section 501(a) is treated as having made an election under this section to be classified as an association. Such election will be effective as of the first day for which exemption is claimed or determined to apply, regardless of when the claim or determination is made, and will remain in effect unless an election is made under paragraph (c)(1)(i) of this section after the date the claim for exempt status is withdrawn or rejected or the date the determination of exempt status is revoked.

(B) *Real estate investment trusts*. An eligible entity that files an election under section 856(c)(1) to be treated as a real estate investment trust is treated as having made an election under this section to be classified as an association. Such election will be effective as of the first day the entity is treated as a real estate investment trust.

(vi) *Examples*. The following examples illustrate the rules of this paragraph (c)(1):

Example 1. On July 1, 1998, X, a domestic corporation, purchases a 10% interest in Y, an eligible entity formed under Country A law in 1990. The entity's classification was not relevant to any person for federal tax or information purposes prior to X's acquisition of an interest in Y. Thus, Y is not considered to be in existence on the effective date of this section for purposes of paragraph (b)(3) of this section. Under the applicable Country A statute, all members of Y have limited liability as defined in paragraph (b)(2)(ii) of this section. Accordingly, Y is classified as an association under paragraph (b)(2)(i)(B) of this section unless it elects under this paragraph (c) to be classified as a partnership. To be classified as a partnership as of July 1, 1998, Y must file a Form 8832 by September 14, 1998. See paragraph (c)(1)(i) of this section. Because an election cannot be effective more than 75 days prior to the date on which it is filed, if Y files its Form 8832 after September 14, 1998, it will be classified as an association from July 1, 1998, until the effective date of the election. In that case, it could not change its classification by election under this paragraph (c) during the sixty months succeeding the effective date of the election.

Example 2. (i) Z is an eligible entity formed under Country B law and is in existence on the effective date of this section within the meaning of paragraph (b)(3) of this section. Prior to the effective date of this section, Z claimed to be classified as an association. Unless Z files an election under this paragraph (c), it will continue to be classified as an association under paragraph (b)(3) of this section.

(ii) Z files a Form 8832 pursuant to this paragraph (c) to be classified as a partnership, effective as of the effective date of this section. Z can file an election to be classified as an association at any time thereafter, but then would not be permitted to change its classification by election during the sixty months succeeding the effective date of that subsequent election.

(2) *Authorized signatures*—(i) *In general*. An election made under paragraph (c)(1)(i) of this section must be signed by—

(A) Each member of the electing entity who is an owner at the time the election is filed; or

(B) Any officer, manager, or member of the electing entity who is authorized (under local law or the entity's organizational documents) to make the election and who represents to having such authorization under penalties of perjury.

(ii) *Retroactive elections*. For purposes of paragraph (c)(2)(i) of this section, if an election under paragraph (c)(1)(i) of this section is to be effective for any period prior to the time that it is filed, each person who was an owner between the date the election is to be effective and the date the election is filed, and who is not an owner at the time the election is filed, must also sign the election.

(iii) *Changes in classification*. For paragraph (c)(2)(i) of this section, if an election under paragraph (c)(1)(i) of this section is made to change the classification of an entity, each person who was an owner on the date that any transactions under paragraph (g) of this section are deemed to occur, and who is not an owner at the time the election is filed, must also sign the election. This paragraph (c)(2)(iii) applies to elections filed on or after November 29, 1999.

* * *

(g) *Elective changes in classification*—(1) *Deemed treatment of elective change*—(i) *Partnership to association*. If an eligible entity classified as a partnership elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.

(ii) *Association to partnership*. If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be classified as a partnership, the following is deemed to occur: The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.

(iii) *Association to disregarded entity*. If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be disregarded as an entity separate from its owner, the following is deemed to occur: The association distributes all of its assets and liabilities to its single owner in liquidation of the association.

(iv) *Disregarded entity to an association*. If an eligible entity that is disregarded as an entity separate from its owner elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The owner of the eligible entity contributes all of the assets and liabilities of the entity to the association in exchange for stock of the association.

(2) *Effect of elective changes*. The tax treatment of a change in the classification of an entity for federal tax purposes by election under paragraph (c)(1)(i) of this section is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

(3) *Timing of election*—(i) *In general*. An election under paragraph (c)(1)(i) of this section that changes the classification of an eligible entity for federal tax purposes is treated as occurring at the start of the day for which the election is effective. Any transactions that are deemed to occur under this paragraph (g) as a result of a change in classification are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification of an entity from an association to a partnership effective on January 1, the deemed transactions specified in paragraph (g)(1)(ii) of this section (including the liquidation of the association) are treated as occurring immediately before the close of December 31 and must be reported by the owners of the entity on December 31. Thus, the last day of the association's taxable year will be December 31 and the first day of the partnership's taxable year will be January 1.

(ii) *Coordination with section 338 election.* A purchasing corporation that makes a qualified stock purchase of an eligible entity taxed as a corporation may make an election under section 338 regarding the acquisition if it satisfies the requirements for the election, and may also make an election to change the classification of the target corporation. If a taxpayer makes an election under section 338 regarding its acquisition of another entity taxable as a corporation and makes an election under paragraph (c) of this section for the acquired corporation (effective at the earliest possible date as provided by paragraph (c)(1)(iii) of this section), the transactions under paragraph (g) of this section are deemed to occur immediately after the deemed asset purchase by the new target corporation under section 338.

(iii) *Application to successive elections in tiered situations.* When elections under paragraph (c)(1)(i) of this section for a series of tiered entities are effective on the same date, the eligible entities may specify the order of the elections on Form 8832. If no order is specified for the elections, any transactions that are deemed to occur in this paragraph (g) as a result of the classification change will be treated as occurring first for the highest tier entity's classification change, then for the next highest tier entity's classification change, and so forth down the chain of entities until all the transactions under this paragraph (g) have occurred. For example, Parent, a corporation, wholly owns all of the interest of an eligible entity classified as an association (S1), which wholly owns another eligible entity classified as an association (S2), which wholly owns another eligible entity classified as an association (S3). Elections under paragraph (c)(1)(i) of this section are filed to classify S1, S2, and S3 each as disregarded as an entity separate from its owner effective on the same day. If no order is specified for the elections, the following transactions are deemed to occur under this paragraph (g) as a result of the elections, with each successive transaction occurring on the same day immediately after the preceding transaction S1 is treated as liquidating into Parent, then S2 is treated as liquidating into Parent, and finally S3 is treated as liquidating into Parent.

(4) *Effective date*. This paragraph (g) applies to elections that are filed on or after November 29, 1999. Taxpayers may apply this paragraph (g) retroactively to elections filed before November 29, 1999 if all taxpayers affected by the deemed transactions file consistently with this paragraph (g).

* * *

26 C.F.R. § 1.367(b)-3 (2000)

§ 1.367(b)–3 Repatriation of foreign corporate assets in certain non-recognition transactions.

* * *

(b) *Exchange of stock owned directly by a United States shareholder or by certain foreign corporate shareholders—(1) Scope*. This paragraph (b) applies in the case of an exchanging shareholder that is either—

(i) A United States shareholder of the foreign acquired corporation; or

(ii) A foreign corporation with respect to which there are one or more United States shareholders.

(2) *United States shareholder*. For purposes of this section (and for purposes of the other section 367(b) regulation provisions that specifically refer to this paragraph (b)(2)), the term *United States shareholder* means any shareholder described in section 951(b) (without regard to whether the foreign corporation is a controlled foreign corporation), and also any shareholder described in section 953(c)(1)(A) (but only if the foreign corporation is a controlled foreign corporation subject to the rules of section 953(c)).

(3) *Income inclusion*—(i) *Inclusion of all earnings and profits amount*. An exchanging shareholder shall include in income as a deemed dividend the all earnings and profits amount with respect to its stock in the foreign acquired corporation. For the consequences of the deemed dividend, see § 1.367(b)–2(e). Notwithstanding § 1.367(b)–2(e), however, a deemed dividend from the foreign acquired

corporation to an exchanging foreign corporate shareholder shall not qualify for the exception from foreign personal holding company income provided by section 954(c)(3)(A)(i), although it may qualify for the look-through treatment provided by section 904(d)(3) if the requirements of that section are met with respect to the deemed dividend.

(ii) *Examples*. The following examples illustrate the rules of paragraph (b)(3)(i) of this section:

Example 1— (i) *Facts*. DC, a domestic corporation, owns all of the outstanding stock of FC, a foreign corporation. The stock of FC has a value of $100, and DC has a basis of $30 in such stock. The all earnings and profits amount attributable to the FC stock owned by DC is $20, of which $15 is described in section 1248(a) and the remaining $5 is not (for example, because it accumulated prior to 1963). FC has a basis of $50 in its assets. In a liquidation described in section 332, FC distributes all of its property to DC, and the FC stock held by DC is canceled.

(ii) *Result*. Under paragraph (b)(3)(i) of this section, DC must include $20 in income as a deemed dividend from FC. Under section 337(a) FC does not recognize gain or loss in the assets that it distributes to DC, and under section 334(b), DC takes a basis of $50 in such assets. Because the requirements of section 902 are met, DC qualifies for a deemed paid foreign tax credit with respect to the deemed dividend that it receives from FC.

Example 2— (i) *Facts*. DC, a domestic corporation, owns all of the outstanding stock of FC, a foreign corporation. The stock of FC has a value of $100, and

DC has a basis of $30 in such stock. The all earnings and profits amount attributable to the FC stock owned by DC is $75. FC has a basis of $50 in its assets. In a liquidation described in section 332, FC distributes all of its property to DC, and the FC stock held by DC is canceled.

(ii) *Result*. Under paragraph (b)(3)(i) of this section, DC must include $75 in income as a deemed dividend from FC. Under section 337(a) FC does not recognize gain or loss in the assets that it distributes to DC, and under section 334(b), DC takes a basis of $50 in such assets. Because the requirements of section 902 are met, DC qualifies for a deemed paid foreign tax credit with respect to the deemed dividend that it receives from FC.

Example 3— (i) *Facts*. DC, a domestic corporation, owns 80 percent of the outstanding stock of FC, a foreign corporation. DC has owned its 80 percent interest in FC since FC was incorporated. The remaining 20 percent of the outstanding stock of FC is owned by a person unrelated to DC (the minority shareholder). The stock of FC owned by DC has a value of $80, and DC has a basis of $24 in such stock. The stock of FC owned by the minority shareholder has a value of $20, and the minority shareholder has a basis of $18 in such stock. FC's only asset is land having a value of $100, and FC has a basis of $50 in the land. Gain on the land would not generate earnings and profits qualifying under section 1248(d) for an exclusion from earnings and profits for purposes of section 1248. FC has earnings and profits of $20 (determined under the rules of § 1.367(b)–2(d)(2)(i) and (ii)), $16 of which is attributable to the stock owned by DC under the rules of § 1.367(b)–

2(d)(3). FC subdivides the land and distributes to the minority shareholder land with a value of $20 and a basis of $10. As part of the same transaction, in a liquidation described in section 332, FC distributes the remainder of its land to DC, and the FC stock held by DC and the minority shareholder is canceled.

(ii) *Result*. Under section 336, FC must recognize the $10 of gain it realizes in the land it distributes to the minority shareholder, and under section 331 the minority shareholder recognizes its gain of $2 in the stock of FC. Such gain is included in income by the minority shareholder as a dividend to the extent provided in section 1248 if the minority shareholder is a United States person that is described in section 1248(a)(2). Under § 1.367(b)–2(d)(2)(iii), the $10 of gain recognized by FC increases its earnings and profits for purposes of computing the all earnings and profits amount and, as a result, $8 of such increase (80 percent of $10) is considered to be attributable to the FC stock owned by DC under § 1.367(b)–2(d)(3)(i)(A)(*1*). DC's all earnings and profits amount with respect to its stock in FC is $24 (the $16 of initial all earnings and profits amount with respect to the FC stock held by DC, plus the $8 addition to such amount that results from FC's recognition of gain on the distribution to the minority shareholder). Under paragraph (b)(3)(i) of this section, DC must include the $24 all earnings and profits amount in income as a deemed dividend from FC.

Example 4— (i) *Facts*. DC1, a domestic corporation, owns all of the outstanding stock of DC2, a domestic corporation. DC1 also owns all of the outstanding stock of FC, a foreign corporation. The stock of FC has a value of $100, and DC1 has a basis of \$30 in such stock. The assets of FC have a value of \$100. The all earnings and profits amount with respect to the FC stock owned by DC1 is \$20. In a reorganization described in section 368(a)(1)(D), DC2 acquires all of the assets of FC solely in exchange for DC2 stock. FC distributes the DC2 stock to DC1, and the FC stock held by DC1 is canceled.

(ii) *Result*. DC1 must include \$20 in income as a deemed dividend from FC under paragraph (b)(3)(i) of this section. Under section 361, FC does not recognize gain or loss in the assets that it transfers to DC2 or in the DC2 stock that it distributes to DC1, and under section 362(b) DC2 takes a basis in the assets that it acquires from FC equal to the basis that FC had therein. Under § 1.367(b)–2(e)(3)(ii) and section 358(a)(1), DC1 takes a basis of \$50 (its \$30 basis in the stock of FC, plus the \$20 that was treated as a deemed dividend to DC1) in the stock of DC2 that it receives in exchange for the stock of FC. Under § 1.367(b)–2(e)(3)(iii) and section 312(a), the earnings and profits of FC are reduced by the \$20 deemed dividend.

Example 5— (i) *Facts*. DC1, a domestic corporation, owns all of the outstanding stock of DC2, a domestic corporation. DC1 also owns all of the outstanding stock of FC1, a foreign corporation. FC1 owns all of the outstanding stock of FC2, a foreign corporation. The all earnings and profits amount with respect to the FC2 stock owned by FC1 is \$20. In a reorganization described in section 368(a)(1)(D), DC2 acquires all of the assets and liabilities of FC2 in exchange for DC2 stock. FC2 distributes the DC2 stock to FC1, and the FC2 stock held by FC1 is canceled.

(ii) *Result*. FC1 must include $20 in income as a deemed dividend from FC2 under paragraph (b)(3)(i) of this section. The deemed dividend is treated as a dividend for purposes of the Internal Revenue Code as provided in § 1.367(b)–2(e)(2); however, under paragraph (b)(3)(i) of this section the deemed dividend cannot qualify for the exception from foreign personal holding company income provided by section 954(c)(3)(A)(i), even if the provisions of that section would otherwise have been met in the case of an actual dividend.

Example 6. (i) *Facts*. DC1, a domestic corporation, owns 99 percent of USP, a domestic partnership. The remaining 1 percent of USP is owned by a person unrelated to DC1. DC1 and USP each directly own 9 percent of the outstanding stock of FC, a foreign corporation that is not a controlled foreign corporation subject to the rule of section 953(c). In a reorganization described in section 368(a)(1)(C), DC2, a domestic corporation, acquires all of the assets and liabilities of FC in exchange for DC2 stock. FC distributes to its shareholders DC2 stock, and the FC stock held by its shareholders is canceled.

(ii) *Result*. (A) DC1 and USP are United States persons that are exchanging shareholders in a transaction described in paragraph (a) of this section. As a result, DC1 and USP are subject to the rules of paragraph (b) of this section if they qualify as United States shareholders as defined in paragraph (b)(2) of this section. Alternatively, if they do not qualify as United States shareholders as defined in paragraph (b)(2) of this section, DC1 and USP are subject to the rules of paragraph (c) of this section. Paragraph (b)(2) of this section defines the term United States shareholder to include any shareholder described in section 951(b) (without regard to whether the foreign corporation is a controlled foreign corporation). A shareholder described in section 951(b) is a United States person that is considered to own, applying the rules of section 958(a) and 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation. Under section 958(b), the rules of section 318(a), as modified by section 958(b) and the regulations thereunder, apply so that, in general, stock owned directly or indirectly by a partnership is considered as owned proportionately by its partners, and stock owned directly or indirectly by a partner is considered as owned by the partnership. Thus, under section 958(b), DC1 is treated as owning its proportionate share of FC stock held by USP, and USP is treated as owning all of the FC stock held by DC1.

(B) Accordingly, for purposes of determining whether DC1 is a United States shareholder under paragraph (b)(2) of this section, DC1 is considered as owning 99 percent of the 9 percent of FC stock held by USP. Because DC1 also owns 9 percent of FC stock directly, DC1 is considered as owning more than 10 percent of FC stock. DC1 is thus a United States shareholder of FC under paragraph (b)(2) of this section and, as a result, is subject to the rules of paragraph (b) of this section. However, for purposes of determining DC1's all earnings and profits amount, DC1 is not treated as owning the FC stock held by USP. Under § 1.367(b)–2(d)(3), DC1's all earnings and profits amount is determined by reference to the 9 percent of FC stock that it directly owns.

(C) For purposes of determining whether USP is a United States shareholder under paragraph (b)(2) of this section, USP is considered as owning the 9 percent of FC stock held by DC1. Because USP also owns 9 percent of FC stock directly, USP is considered as owning more than 10 percent of FC stock. USP is thus a United States shareholder of FC under paragraph (b)(2) of this section and, as a result, is subject to the rules of paragraph (b) of this section. However, for purposes of determining USP's all earnings and profits amount, USP is not treated as owning the FC shares held by DC1. Under § 1.367(b)–2(d)(3), USP's all earnings and profits amount is determined by reference to the 9 percent of FC stock that it directly owns.

(iii) *Recognition of exchange gain or loss with respect to capital*. [Reserved]

(4) *Reserved*. For further guidance concerning section 367(b) exchanges occurring before February 23, 2001, see § 1.367(b)–3T(b)(4).

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§ 1.367(b)–3T Repatriation of foreign corporate assets in certain nonrecognition transactions (temporary)

(a) through (b)(3). [Reserved]. For further guidance, see § 1.367(b)–3(a) through (b)(3).

(4) *Election of taxable exchange treatment*—(i) *Rules*—(A) *In general*. In lieu of the treatment prescribed by § 1.367(b)–3(b)(3)(i), an exchanging shareholder described in § 1.367(b)–3(b)(1) may instead elect to recognize the gain (but not loss) that it realizes in the exchange (taxable exchange election). To make a taxable exchange election, the following requirements must be satisfied—

(*1*) The exchanging shareholder (and its direct or indirect owners that would be affected by the election, in the case of an exchanging shareholder that is a foreign corporation) reports the exchange in a manner consistent therewith (see, e.g., sections 954(c)(1)(B)(i), 1001 and 1248);

(*2*) The notification requirements of paragraph (b)(4)(i)(C) of this section are satisfied; and

(*3*) The adjustments described in paragraph (b)(4)(i)(B) of this section are made when the following circumstances are present—

(*i*) The transaction is described in section 332 or is an asset acquisition described in section 368(a)(1), with regard to which one U.S. person owns (directly or indirectly) 100 percent of the foreign acquired corporation; and

(*ii*) The all earnings and profits amount described in § 1.367(b)–3(b)(3)(i) with respect to the exchange exceeds the gain recognized by the exchanging shareholder.

(B) *Attribute reduction*—(*1*) *Reduction of NOL carryovers*. The amount by which the all earnings and profits amount exceeds the gain recognized by the exchanging shareholder (the excess earnings and profits amount) shall be applied to reduce the net operating loss carryovers (if any) of the foreign acquired corporation to which the domestic acquiring corporation would otherwise succeed under section 381(a) and (c)(1). See also Rev. Rul. 72–421 (1972–2 C.B. 166) (see § 601.601(d)(2) of this chapter).

(*2*) *Reduction of capital loss carryovers*. After the application of paragraph (b)(4)(i)(B)(*1*) of this section, any remaining excess earnings and profits amount shall be applied to reduce the capital loss carryovers (if any) of the foreign acquired corporation to which the domestic acquiring corporation would otherwise succeed under section 381(a) and (c)(3).

(*3*) *Reduction of basis*. After the application of paragraph (b)(4)(i)(B)(2) of this section, any remaining excess earnings and profits amount shall be applied to reduce (but not below zero) the basis of the assets (other than dollar-denominated money) of the foreign acquired corporation that are acquired by the domestic acquiring corporation. Such remaining excess earnings and profits amount shall be applied to reduce the basis of such assets in the following order: first, tangible depreciable or depletable assets, according to their class lives (beginning with those assets with the shortest class life); second, other non-inventory tangible assets; third, intangible assets that are amortizable; and finally, the remaining assets of the foreign acquired corporation that are acquired by the domestic acquiring corporation. Within each of these categories, if the total basis of all assets in the category is greater than the excess earnings and profits amount to be applied against such basis, the taxpayer may choose to which specific assets in the category the basis reduction first applies.

(C) *Notification*. The exchanging shareholder shall elect to apply the rules of this paragraph (b)(4)(i) by attaching a statement of its election to its section 367(b) notice. See § 1.367(b)–1(c) For the rules concerning filing a section 367(b) notice.

(D) *Example*— The following example illustrates the rules of this paragraph (b)(4)(i):

Example. (i) *Facts*. DC, a domestic corporation, owns all of the outstanding stock of FC, a foreign corporation. The stock of FC has a value of $100, and DC has a basis of $80 in such stock. The assets of FC are one parcel of land with a value of $60 and a basis of $30, and tangible depreciable assets with a value of $40 and a basis of $80. FC has no net operating loss carryovers or capital loss carryovers. The all earnings and profits amount with respect to the FC stock owned by DC is $30, of which $19 is described in section 1248(a) and the remaining $11 is not (for example, because it was earned prior to 1963). In a liquidation described in section 332, FC distributes all of its property to DC, and the FC stock held by DC is canceled. Rather than including in income as a deemed dividend the all earnings and profits amount of $30 as provided in § 1.367(b)–3(b)(3)(i), DC instead elects taxable exchange treatment under paragraph (b)(4)(i)(A) of this section.

(ii) *Result*. DC recognizes the $20 of gain it realizes on its stock in FC. Of this $20 amount, $19 is included in income by DC as a dividend pursuant to section 1248(a). (For the source of the remaining $1 of gain recognized by DC, see section 865. For the treatment of the $1 for purposes of the foreign tax credit limitation, see generally section 904(d)(2)(A)(i).) Because the transaction is described in section 332 and because the all earnings and profits amount with respect to the FC stock held by DC ($30) exceeds by $10 the income recognized by DC ($20), the attribute reduction rules of paragraph (b)(4)(i)(B) of this section apply. Accordingly, the $10 excess earnings and profits amount is applied to reduce the basis of the tangible depreciable assets of FC, beginning with those assets with the shortest class lives. Under section 337(a) FC does not recognize gain or loss in the assets that it distributes to DC, and under section 334(b) (which is applied taking into account the basis reduction prescribed by paragraph (b)(4)(i)(A)(*3*) of this section) DC takes a basis of $30 in the land and $70 in the tangible depreciable assets that it receives from FC.

(ii) *Effective date*. This paragraph (b)(4) applies for section 367(b) exchanges that occur between February 23, 2000, and February 23, 2001.

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