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**IRS TOUTS A SIGNIFICANT WIN IN A RECENT  
SON OF BOSS TAX SHELTER CASE:  
*Stobie Creek Investments LLC et al. v. United States***

**Executive Summary**

On July 31, 2008, the United States Court of Federal Claims found Stobie Creek Investments LLC to be a Son of Boss tax shelter which was created to avoid tax on \$204 million in capital gain realized on the sale of a family's business.<sup>1</sup> The case represents a significant loss for those tracking the Son of Boss cases involving foreign exchange digital option transfers (FXDOTs) and for other types of tax disputes relating to investment strategies which are being challenged by the Service on economic substance grounds. "We are pleased that yet another court has delved into the workings of this manufactured tax shelter and found it to be deficient," said John DiCicco, Assistant Attorney General of the Justice Department's Tax Division in a press release. "We hope other taxpayers who seek to defend this patently abusive shelter will heed this decision and abandon their efforts to defend the indefensible. For our part, the Department of Justice will redouble its efforts to expose and defeat these blatant attempts to raid the Treasury."

Readers of this Alert should contact one of the HRO partners listed in the margin to discuss the *Stobie Creek* case and its potential impact on future tax litigation.

**Background Facts**

Therma-Tru was a family owned corporation founded by David Welles, which primarily manufactured and sold residential doors. Mr. Welles had explored the possibility of selling Therma-Tru in 1987, the year he was diagnosed with cancer. Poor economic conditions at that time caused Mr. Welles to abandon the plan to sell Therma-Tru. By 1999, Therma-Tru had grown larger and more successful, and David Welles and his wife had already transferred much of the company to their children. The family again explored the possibility of selling the business in late 1999. Though the family had entered into negotiations to sell the business via a tax-free stock exchange worth approximately \$825 million, that deal fell through. Thereafter, the Welles family began to negotiate with a private equity firm called Kenner and Company. By December 8, 1999, the family had reached an agreement to sell half of their Therma-Tru stock to Kenner for \$425 million.

Although the capital gain on the sale of the Welles' stock would be taxable, the family's long-time attorneys at Schumaker, Loop & Kendrick ("Schumaker") advised them of a tax strategy which had been created by Jenkins & Gilchrist, P.C. ("Jenkins") that would offset nearly all of the gain. The Schumaker attorneys provided the Welles with a redacted copy of a tax opinion Jenkins had prepared for another Schumaker client, which outlined the following six steps where the taxpayer would do the following:

1. The taxpayer would simultaneously hold the long and the short option position on a foreign currency through a single member LLC;
2. The taxpayer would contribute the options to a partnership;
3. The taxpayer would claim an interest in the partnership equal to the value of the long option;
4. The partnership would close the option positions based upon market timing factors, or the options would merely expire, thereby causing the partnership to recognize gain or loss;

<sup>1</sup> *Stobie Creek Investments LLC v. United States*, Fed. Cl., No. 05-748T (July 31, 2008).

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5. Once the partnership closed the options and realized a gain or a loss, the taxpayer would either contribute his or her share to an S corporation or would allow his or her share to be redeemed by the partnership;
6. The taxpayer's assets would, therefore, obtain a high basis before the assets are sold.

The Jenkins opinion specifically required that a "business and/or investment reason for the investment strategy must exist." It was agreed that the Jenkins firm would earn 2% on the value of the gain to be sheltered as compensation for the use of its strategy, and Schumaker would earn an additional 1% of the gain to be sheltered. The total fees paid by the Welles family to both law firms ultimately totaled approximately \$6.1 million.

The Stobie Creek partnership was formed on March 3, 2000. The partners were single-member LLCs owned by members of the Welles family. On the same day, the attorneys sent an agreement to the family which would permit Stobie Creek to receive the cash from the sale of Therma-Tru to Kenner. The Schumaker lawyers sent the family a letter reminding them that they must have a non-tax purpose for engaging in the Jenkins transaction or Schumaker may not be able to issue an opinion, even if the firm was permitted to do so under confidentiality restrictions.

On March 31, 2000, each of the family's single-member LLC's entered into a pair of FXDOTs. The first pair was an option collar involving a long option and a short option on the value of the Swiss franc versus the US dollar; the second pair was an option collar involving a long option and a short option on the value of the dollar versus the euro. Both pairs of options closed on April 17, 2000.

In August, 2000, the IRS released Notice 2000-44, which, according to Schumaker, described "two or three different types of investment structures, at least one of which looked similar to the transaction that had been engaged in or pursued by the Welles family." However, Jenkins analyzed the applicability of the Notice 2000-44 on the Welles family's transaction and concluded it was not applicable to their transaction. Jenkins agreed to provide an analysis regarding the applicability of Notice 2000-44 to the Welles transaction in their opinion letter.

In January, 2001, Jenkins sent the Welles a final tax opinion letter regarding the Stobie Creek transaction, which represented that the family had "substantial non-tax reasons" for entering into the transaction and that Jenkins had been provided with all the facts and circumstances necessary for it to form its opinion, with a "more likely than not confidence level" that the transaction could be supported for tax purposes.

## Issues Presented At Trial

The five issues presented at trial were as follows: (1) whether the partnership's transactions and reporting were in literal compliance with the Internal Revenue Code; (2) whether any allowable tax loss was rendered retroactively disallowed by Treas. Reg. §1.752-6; (3) whether the transaction should be disallowed under the economic substance doctrine; (4) whether the transaction should be disregarded under the step-transaction doctrine; and (5) whether the 40% accuracy related penalty for a gross valuation misstatement applies to the transaction.

## Federal Claims Court's Conclusions

While the Court concluded that the transaction followed the literal meaning of the Internal Revenue Code, the transaction failed under the economic substance doctrine. Moreover, while Treas. Reg. §1.752-6 could not be applied by the Service retroactively to invalidate the Welles family's transaction, the Service prevailed in attacking the transaction under the broad-sweeping economic substance doctrine.

Under the economic substance theory, the Court must generally inquire whether the taxpayer had both a subjective and objective reasonable expectation of making a profit aside from the tax benefits. The taxpayer presented several experts to show that the FXDOTs had a reasonable expectation of profit, but the Court found that the IRS's single expert was far more persuasive than the taxpayer's experts, whose opinions were found to be selective and incomplete. The taxpayer claimed they had a 30% likelihood of doubling their investment in the transaction, but the Court found that the probability that the taxpayer could achieve a profit was less than 12%. Moreover, the Court found the law firms' fee structure to be an indication that the parties' intent was tax savings, because the amount of fees paid to the law firm was a percentage of the tax benefits gained. "The fees related to the implementation of the [Jenkins] strategy, exclusive of the options premiums paid on the order of over \$6 million, further overwhelm what little possibility of profit could have been produced by the FXDOTs," the Court stated.

The Court was extremely critical of the Welles family's claimed profit motives. Again, the fee structure between the lawyers who structured the transaction, which were tied to the tax benefits to be gained, was very strong evidence that the transaction was solely motivated by tax avoidance rather than investment or business purposes. "The court is satisfied that the relevant transactions lacked objective economic reality," Judge Miller concluded.

The *Stobie Creek* Court distinguished the *Sala*<sup>2</sup> decision where the U.S. District Court of Colorado recently found that the taxpayer's claimed losses of over \$60 million in connection with a series of complex transactions involving foreign currency option contracts had economic substance. In *Sala*, the IRS's expert's testimony was unconvincing, while his testimony was more persuasive in *Stobie Creek*. In *Sala*, odds were more than 50% for producing a profit, which wasn't present in the *Stobie Creek* transaction. Moreover, the *Stobie Creek* options were found by the Court to be overpriced, while in *Sala* they actually had produced some profit.

In the end, the Court also found that a 40% penalty for underpayment due to a gross valuation misstatement applied under IRC § 6662.

### Key Observations:

In reviewing the Federal Claims Court's opinion in *Stobie Creek*, several key observations are noted:

- *Consider the Application by the IRS of any Judicial Doctrines.* A transaction which relies upon the highly technical application of one or more Code provisions can be disregarded under the economic substance, step transaction, and substance over form doctrines.
- *Define the Transaction for its Significant Non-tax Purpose.* A transaction which has no purpose other than the avoidance of income taxes generally will not be respected unless the non-tax reasons for entering into the transaction are objectively and subjectively reasonable and those reasons are clearly documented.
- *Complicated Transactions Should be Structured by Qualified Tax Professionals Whose Fees are not Linked to the Tax Benefits to be Gained from the Structure.* The *Stobie Creek* professionals' fees were a percentage of the tax benefits to be gained in the transaction which nullified any argument that the transaction was entered into for non-tax business reasons.
- *Forum Selection in the Event of a Dispute.* Taxpayers generally have a variety of judicial venues to choose from when litigating a tax dispute. The Federal Claims Court's opinion in *Stobie Creek* and other Claims Court cases are an indicator that future taxpayers may want to consider other potential venues where economic substance is an issue.

<sup>2</sup> *Sala v. United States*, 552 F.Supp 1167 (D. Colo. 2008).

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