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Authored by David B. Strong

COLORADO DISTRICT COURT REACHES TAXPAYER-FAVORABLE RESULT IN RECENT TAX SHELTER CASE

Executive Summary

In *Sala v. United States* (decided April 22, 2008), Judge Lewis Babcock of the U.S. District Court for the District of Colorado upheld an individual taxpayer's claimed loss of over \$60 million in connection with a series of complex transactions involving foreign currency option contracts. The case represents a notable defeat for the Internal Revenue Service ("IRS") in its current "Son of BOSS" litigation efforts being pursued nationwide. The case also creates a potentially favorable precedent within the Colorado District Court for future "Son of BOSS" (bond option sales strategy) cases and for other types of tax disputes relating to tax-advantaged transactions and investment strategies. Readers of this alert should feel free to contact one of the HRO tax partners listed in the margin to discuss the *Sala* case and its potential implications for tax litigation matters.

Background Facts

In 1997, Mr. Carlos E. Sala ("Sala") became employed as CFO, Secretary, and Treasurer of Abacus Direct, Inc. Sala's compensation included cash and stock options. In June 1999, Abacus was acquired by DoubleClick, Inc. In connection with the acquisition, Sala received DoubleClick stock options. Sala sold his DoubleClick options in February or March of 2000. Largely as a result of the sale of these options, Sala realized more than \$60 million in income in 2000.

Sala invested most of this income into municipal bonds and other fixed income financial products. Approximately \$9 million, however, was invested in a foreign currency investment program (the "Deerhurst Program"). As part of the Deerhurst Program, Sala deposited \$500,000 on October 23, 2000, into a personal account at Refco Capital Markets ("Refco") that was managed by Deerhurst Management Company, Inc. ("Deerhurst Management"). Deerhurst Management was principally owned and managed by Andrew Krieger, a renowned foreign currency trader.

On November 21, 2000, Sala deposited an additional \$8,425,000 into his personal account at Refco. Between November 20 and November 27, 2000, Deerhurst Management acquired 24 foreign currency options on Sala's behalf. The options consisted of both long and short options in various foreign currencies with a net cost to Sala of approximately \$728,297.85.

On November 8, 2000, Sala formed Solid Currencies, Inc. ("Solid"), a Delaware S Corporation in which he was the sole shareholder. On November 28, 2000, Sala transferred the 24 options, plus approximately \$8 million in cash, to Solid and then from Solid to Deerhurst Investors, GP ("Deerhurst GP") in exchange for a partnership interest. Deerhurst GP was liquidated prior to December 31, 2000, approximately one month after Solid made its initial contribution of the 24 options and \$8 million in cash to Deerhurst GP. Upon liquidation of Deerhurst GP, Solid received a share of the proceeds. Solid transferred its share of the Deerhurst GP proceeds to Deerhurst Trading LLC. Krieger continued to manage these funds on behalf of Sala in various entities through 2004.

Sala subsequently filed a corporate income tax return for Solid for the 2000 tax year. The return reported an ordinary loss from a trade or business of \$60,449,984. The approximately \$60 million loss claimed was allegedly achieved by a series of predetermined steps, orchestrated under a then-existing tax rule that disregarded short options as liabilities for purposes of establishing partnership basis. Under this rule, established in *Helmer v. Commissioner of Internal Revenue*, T.C. Memo 1975-160 (1975), liabilities created by short options were considered too contingent to affect a partner's basis in the partnership. Upon transfer of the 24 foreign currency options from Sala to Solid and then to Deerhurst GP, Solid's basis in Deerhurst GP was increased by the value of the long options,

HRO CONTACTS

David B. Strong
Partner
david.strong@hro.com
303-866-0263

G. Michelle Ferreira
Partner
michelle.ferreira@hro.com
415-268-1905



Holme Roberts & Owen LLP
Attorneys at Law

\$60,987,866.79, but was not offset by the \$60,259,568.94 cost of the short options. Accordingly, Solid's claimed basis in Deerhurst GP was approximately \$69 million (equal to the value of the cash plus the long options).

Upon the liquidation of Deerhurst GP in December of 2000, Solid received a portion of Deerhurst GP's liquidated assets equal to the proportionate size of Solid's basis. Solid claimed to have received approximately \$8 million in cash and two foreign currency contracts. The value of the foreign exchange contracts distributed to Solid was claimed to be approximately \$61 million (Solid's original basis in Deerhurst GP of \$69 million, less the \$8 million in cash). When Solid sold the foreign currency contracts, its claimed loss was equal to the \$61 million dollar value of the contracts, offset by any profit received from their sale. According to Solid's 2000 tax return, the combined loss on the foreign currency contracts was approximately \$60,250,065.94. Sala then reported the significant loss attributable to the activities of Solid as a non-passive loss on his 2000 individual return, which was then used to offset over \$60 million of income realized in 2000 that would have otherwise been subject to federal income tax.

Issues Presented At Trial

Five distinct issues were presented at trial: (1) whether the transactions creating Sala's 2000 tax loss had independent economic significance and were not "sham" transactions; (2) whether Sala had a subjective profit motive when he entered into the transactions; (3) whether the transactions creating Sala's 2000 tax loss, as executed, actually allowed the tax loss; (4) whether any allowable tax loss was rendered retroactively disallowed by Treasury Regulation Section 1.752-6; and (5) whether the IRS was entitled to an offset of any excess interest payments made by Sala with an accuracy-related penalty.

District Court's Conclusions

The District Court concluded in favor of Sala and against the IRS with respect to all five issues.

Observations/Best Practices

In reviewing the District Court's opinion in *Sala v. United States*, several key observations and best practices emerge that should be kept in mind by taxpayers considering tax-advantaged transactions:

- *Maintain Adequate Records* – Taxpayers should always be sure to maintain adequate records in connection with a transaction – in the event of a dispute, such documentation will prove invaluable in an attempt to shift the factual "burden of proof" to the IRS under Section 7491 of the Code.
- *Define the "Transaction" as Broadly as Possible* – Taxpayers should always seek to define and document the "transaction" in a way that integrates potential tax benefits with other non-tax business objectives and risk taking activities.
- *Substantiate both "Objective" and "Subjective" Profit Potential* – Taxpayers should ensure that a transaction is documented in a way that demonstrates both "objective" pre-tax profit potential (based on historical data) as well as a "subjective" pre-tax profit motive (based on the actual intent of the taxpayer at the time the transaction was entered into).
- *Evaluate a Transaction in "Overall" Terms* – Taxpayers should evaluate a transaction in terms of its "overall" risk profile and related potential pre-tax and post-tax return; the District Court in *Sala* implicitly held that a potential "worst-case" economic loss of about \$9 million (with no related pre-tax profits) was sufficient to justify a \$60 million tax loss (with roughly \$24 million in after-tax benefits).
- *Consider Potential Application of any "Anti-Abuse" Rules and Judicial Doctrines* – A transaction that relies upon the highly technical application of one or more Code provisions may be potentially subject to attack under any number of "anti-abuse" rules or judicially created doctrines.
- *Forum Selection In the Event of a Dispute* – Taxpayers generally have a variety of potential judicial venues in which they may choose to litigate a tax dispute; the current state of the law in each potential venue should be carefully evaluated with a view toward where a case might be argued.

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