Part III - Administrative, Procedural, and Miscellaneous

Tax Avoidance Using Inflated Basis

Notice 2002-21

The Internal Revenue Service and the Treasury Department have become aware of a type of transaction, described below, that is used by taxpayers to generate tax losses. This Notice alerts taxpayers and their representatives that the tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This Notice also alerts taxpayers, their representatives, and promoters of these transactions of certain responsibilities that may arise from participating in these transactions.

FACTS

In general, the transaction involves the use of a loan assumption agreement to claim an inflated basis in assets acquired from another party. This inflated basis is claimed as a result of a transfer of assets in which a U.S. taxpayer (Taxpayer) becomes jointly and severally liable on indebtedness of the transferor of the assets (Transferor), with the indebtedness having a stated principal amount substantially in excess of the fair market value of the assets transferred. Transferor may not be subject to U.S. tax or otherwise may be indifferent to the federal income tax consequences of the transaction.

In one variation of the transaction, Transferor borrows money from a lender (Lender) on a long term basis such as 30 years (the "Loan"). The amount borrowed may be in a foreign currency. Interest is payable at regular intervals, and principal is due at maturity. The Loan may permit prepayment. The Loan is made with full recourse to Transferor.

Transferor uses the proceeds to purchase assets (the "Assets"), such as short-term deposits, government bonds, or high-grade corporate debt, which may be denominated in a foreign currency. The Assets serve as collateral for the Loan pursuant to a loan agreement. As each interest payment becomes due, the collateral is used to satisfy such payments. Upon maturity or earlier payment, the Loan is satisfied, by its terms, first from the collateral, and only then against Transferor (or Transferor and any party that has assumed the liability as a joint and several obligor) to satisfy any shortfall.

Pursuant to a separate agreement between Transferor and Taxpayer, Transferor transfers a portion of the Assets to Taxpayer in consideration for Taxpayer's agreement to pay a portion of the Loan and become jointly and severally liable to Lender as a co-obligor on the Loan. The fair market value of the Assets transferred to Taxpayer (the "Conveyed Assets") equals the present value of the Loan's principal payment at maturity, determined by using a market rate of interest. Thus, the fair market value of the Conveyed Assets is substantially less than the Loan's stated principal amount. Taxpayer provides substitute collateral for the Loan, equal in value to the Conveyed Assets. The remainder of the Assets owned by Transferor continue to serve as collateral for the Loan.

Also pursuant to the agreement between Transferor and Taxpayer, Transferor agrees to make all interest payments on the Loan, and Taxpayer agrees to pay the principal due at maturity. The co-obligors and Lender anticipate that the collateral will be substantially (if not entirely) sufficient to repay the Loan.

Taxpayer subsequently disposes of the Conveyed Assets for their fair market value. Taxpayer claims that, as a result of its assumption of joint and several liability on the Loan, the entire principal amount of the Loan is included in Taxpayer's basis in the Conveyed Assets. As a result, Taxpayer claims a loss for federal income tax purposes in an amount equal to the excess of the stated principal amount of the Loan over the fair market value of the Conveyed Assets. If the Conveyed Assets are nonfunctional currency, Taxpayer claims an ordinary loss.

ANALYSIS

Section 1012 of the Internal Revenue Code provides that the basis of property is equal to the cost of the property. Section 1.1012-1(a) of the Income Tax Regulations defines "cost" to mean the "amount paid" for the property in cash or other property. Under general tax law principles, the amount paid for property generally includes the amount of the seller's liabilities assumed by the buyer. Commissioner v. Oxford Paper Co., 194 F.2d 190 (2d. Cir. 1952). The inclusion of liabilities in basis by a buyer, however, is predicated on the assumption that the liabilities will be paid in full by the buyer. See Commissioner v.

Tufts, 461 U.S. 300, 308 (1983), 1983-1 C.B. 120, 123.

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

Other cases have limited the portion of an assumed indebtedness that may be taken into account for federal income tax purposes. For example, where two or more persons are liable on the same indebtedness, or hold separate properties subject to the same indebtedness, the amount taken into account for federal income tax purposes by each person generally is based on all the facts and circumstances, including the economic realities of the situation and the parties' expectations as to how the liabilities will be paid. See Maher v. United States, No. 16253-1 (W.D. Mo. 1969) (property was not in substance "subject to" liability where lender was not actually relying on property as collateral); Maher v. Commissioner, 469 F.2d 225 (8th Cir. 1972) (corporation's assumption of primary liability on shareholder's indebtedness becomes taxable dividend only as corporation makes payments as promised); Snowa v. Commissioner, T.C. Memo 1995-336, rev'd on other grounds, 123 F.3d 190 (4th Cir. 1997) (co-obligor's cost of a new residence included only her ratable share of the liability due to state law's right of contribution).

Under the facts and circumstances of the transaction described in this Notice, as a matter of economic reality, the parties will bear responsibility for repayment of the Loan in accordance with their relative ownership of the Assets immediately after the transfer from Transferor to Taxpayer. Accordingly, the Service and the Treasury believe that Taxpayer's basis in the Conveyed Assets is equal to the fair market value of such assets upon their acquisition by Taxpayer. The losses purportedly resulting from the transaction described in this Notice (or substantially similar to the transaction described in this Notice) are not allowable to the extent Taxpayer derives a tax benefit that is attributable to a basis in excess of the fair market value of the Conveyed Assets. The purported tax benefits from these transactions also may be subject to challenge under other provisions of the Code and regulations, including but not limited to § 988 and, in the case of individuals, §§ 165(c)(2) and 465.

In addition, the Service may impose penalties on participants in these transactions or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

Transactions that are the same as, or substantially similar to, the transaction described in this Notice 2002-xx are identified as "listed transactions" for the purposes of §§ 1.6011-4T(b)(2) of the Temporary Income Tax Regulations and 301.6111-2T(b)(2) of the Temporary Procedure and Administrative Regulations. See also § 301.6112-1T, A-4. It should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011-4T(b)(2) and 301.6111-2T(b)(2), such transactions may already be subject to the tax shelter registration and list maintenance requirements of §§ 6111 and 6112 under the regulations issued in February 2000 (§§ 301.6111-2T and 301.6112-1T, A-4), as well as the regulations issued in 1984 and amended in 1986 (§§ 301.6111-1T and 301.6112-1T, A-3). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under § 6707(a), and to the penalty under § 6708(a) if the requirements of § 6112 are not satisfied.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this Notice. These taxpayers are advised to take prompt action to file amended returns.

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