

Passthrough Entity Straddle Tax Shelter

Notice 2002-65

The Internal Revenue Service and the Treasury Department have become aware of a type of transaction, described below,

that is being used by taxpayers for the purpose of generating deductions. 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

This transaction involves a series of pre-planned steps. First, Taxpayer and one or more other shareholders form a corporation that elects to be treated as an S corporation under § 1362(a) of the Internal Revenue Code. Taxpayer initially has a minority stock interest in the S corporation.

The S corporation enters into straddles on foreign currencies and may acquire other assets. The S corporation terminates the gain leg of a foreign currency straddle, and allocates the gain to the shareholders pro rata according to their stock ownership. The gain increases each shareholder's basis in the stock of the S corporation under § 1367(a)(1). The S corporation redeems the stock of all of the shareholders other than Taxpayer, and the other shareholders claim a loss as a result of the redemption. The S corporation files an election under § 1377(a)(2) to treat the S corporation's taxable year as though it consists of two separate taxable years, with the first year ending on the date of the redemption.

After the redemption, the S corporation terminates the loss leg of the foreign currency straddle. In order to maximize the allowable loss, Taxpayer also may engage in a transaction that is intended to increase Taxpayer's basis in the S corporation. For example, Taxpayer may make a loan to the S corporation.

The entire loss from the loss leg of the straddle passes through to Taxpayer, the sole remaining shareholder in the S corporation, under § 1366. The loss reduces Taxpayer's basis in the stock (and indebtedness, if any) of the S corporation under § 1367(a)(2). Due to the reduction in Taxpayer's basis in the S corporation's stock (and indebtedness, if any), Taxpayer will recognize gain when the corporation makes

additional payments to Taxpayer or Taxpayer disposes of Taxpayer's interest in the S corporation.

Similar transactions may be structured using a partnership in the place of the S corporation.

ANALYSIS

The transaction described in this notice has been designed to use a straddle, one or more transitory shareholders, and the rules of subchapter S to allow Taxpayer to claim an immediate loss while deferring an offsetting gain in Taxpayer's investment in the S corporation. The Service intends to challenge the purported tax benefits from this transaction on a number of grounds. First, the Service may disallow Taxpayer's loss under § 165(c)(2) by asserting that the loss was not incurred in a transaction undertaken for profit. *See Smith v. Commissioner*, 78 T.C. 350 (1982) and *Fox v. Commissioner*, 82 T.C. 1001 (1984) (disallowing losses from straddle transactions). Second, the Service may disregard the transitory ownership of the shareholders other than Taxpayer. *See Comtel Corporation v. Commissioner*, 376 F.2d 791 (2d Cir. 1967) (transitory shareholders' interests not respected). Under this argument, the Service would allocate all of the income and losses from the activities of the S corporation to Taxpayer. Third, the Service may disallow Taxpayer's loss deduction under § 269 by asserting that Taxpayer acquired control of the S corporation with the principal purpose of avoiding or evading federal income tax. In addition, the Service may challenge the allowance of the loss deduction based on other statutory provisions, including § 988, and judicial doctrines, including the step transaction doctrine and the doctrines of economic substance, business purpose, and substance over form. Transactions that use a partnership instead of an S corporation also will be challenged under the partnership anti-abuse rule contained in § 1.701-2 of the Income Tax Regulations. *See* § 1.701-2(d) (Ex. 8).

Transactions that are the same as, or substantially similar to, the transaction described in this notice are identified as "listed transactions" for purposes of § 1.6011-4T(b)(2) of the temporary Income Tax Regulations and § 301.6111-2T(b)(2) of the temporary Procedure and Administration Regulations. *See also* § 301.6112-1T, A-4. The transaction described in this notice and

the transaction described in Notice 2002-50, 2002-28 I.R.B. 98, (Partnership Straddle Tax Shelter) are substantially similar transactions. For purposes of § 1.6011-4T(b)(2) and § 301.6111-2T(b)(2), a transaction will be considered the same as, or substantially similar to, the transaction described in this notice even if the gain and loss legs of the straddle are triggered in separate taxable years, or if, at the time relevant for making such determination, the corporation in the transaction has not elected under § 1377(a)(2) to treat the S corporation's taxable year as though it consisted of two separate taxable years. Further, 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), transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the disclosure requirements of § 6011, the tax shelter registration requirements of § 6111 or the list maintenance requirements of § 6112 (§§ 1.6011-4T, 301.6111-1T, 301.6111-2T and 301.6112-1T, A-3 and A-4).

Persons who are required to satisfy the registration requirement of § 6111 with respect to the transaction described in this notice and who fail to do so may be subject to the penalty under § 6707(a). Persons who are required to satisfy the list-keeping requirement of § 6112 with respect to the transaction and who fail to do so may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in this transaction or substantially similar transactions, or, as applicable, on persons who participate in the promotion or reporting of this transaction or substantially similar 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.

The principal author of this notice is Demetri Yatrakis of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Mr. Yatrakis at (202) 622-3060 (not a toll-free call).
