Federal Taxation

Robert Beard

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by Robert Beard*

This Article surveys notable decisions in federal taxation handed down in 2012 by the United States Court of Appeals for the Eleventh Circuit and lower courts appealable to the Eleventh Circuit.[1] This year, the Eleventh Circuit considered questions relating to securities transactions and the statute of limitations on assessment of taxes, while the Tax Court applied the step-transaction doctrine to a capital contribution to a corporation.

I. *CALLOWAY V. COMMISSIONER*

Calloway v. Commissioner[2] addressed one of a number of similar stock loan transactions promoted by a company called Derivium, which was later targeted by the Department of Justice as a tax shelter promoter and sued by a number of investors for fraudulent conduct. The Calloway transaction took the following form. The taxpayer held an appreciated position in IBM stock. In 2001, Derivium agreed to lend Calloway ninety percent of the market value of the stock. The loan was non-recourse and secured by the stock, which was transferred into a Derivium account. Under the parties' agreement, Derivium had full control over the collateral stock, including the power to sell it without notice. The loan had a three-year term, could not be prepaid, and bore interest at a 10.5 percent annual rate, which was not paid currently. At the end of the loan term, the borrower would have the option to surrender the collateral or repay the loan principal and accrued interest to have the collateral stock returned.[3] Though Derivium represented to

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1. For an analysis of federal taxation decided during the prior survey period, see Robert Beard, *Federal Taxation, Eleventh Circuit Survey*, 63 MERCER L. REV. 1267 (2012).
2. 691 F.3d 1315 (11th Cir. 2012).
3. Calloway v. Comm'r, 135 T.C. 26, 28-29 (2010).

investors that it would hold the collateral stock for safekeeping and hedge its risk using a proprietary strategy, in fact, it immediately sold the collateral.[4] When the taxpayer's loan matured in 2004, Calloway elected to surrender the collateral rather than repaying the loan.[5]

The taxpayer did not report the transaction consistently. No gain from the sale of the stock was reported in 2001, but the taxpayer did not report dividends during the loan period or any gain on his decision to surrender the IBM stock in 2004. The Internal Revenue Service (Service) determined that the Derivium agreement amounted to a sale of the stock in 2001 and also imposed a penalty for failure to file a return and for significant understatement of income.[6]

A. *Tax Court Opinion*

The taxpayer petitioned the Tax Court for a redetermination of the deficiency. The issue of whether a transaction represented a sale or a loan of securities was an issue of first impression for the Tax Court.[7] The majority opinion applied a multi-factor test[8] from *Grodt & McKay Realty, Inc. v. Commissioner*.[9] *Grodt & McKay* involved an investment tax credit shelter in which an investor purported to purchase a herd of cattle at a steeply inflated price, paid partly in cash and mostly in the form of a non-recourse note. The cattle continued to be husbanded by the seller. The terms of the sale minimized the investor's economic exposure, but the investor nonetheless claimed a large investment tax credit based on the inflated "purchase" price.[10] In determining that the purported sale was a sham, the court in *Grodt & McKay* provided a list of factors characterizing a sale:

> (1) Whether legal title passes;
> (2) how the parties treat the transaction;
> (3) whether an equity was acquired in the property;
> (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments;
> (5) whether the right of possession is vested in the purchaser;

4. *Id.* at 34. When Derivium loans began to mature and some borrowers repaid their loans and demanded return of their collateral, Derivium was unable to perform, giving rise to a number of lawsuits. *See id.* at 34-35.

5. *Calloway*, 691 F.3d at 1317-19.

6. *Id.* at 1319.

7. *Calloway*, 135 T.C. at 32-33.

8. *Id.* at 33-34.

9. 77 T.C. 1221 (1981).

10. *See id.* at 1222-23, 1234-35.

(6) which party pays the property taxes;
(7) which party bears the risk of loss or damage to the property; and
(8) which party receives the profits from the operation and sale of the property.[11]

Applying the *Grodt & McKay* factors, the Tax Court concluded the taxpayer had sold his IBM stock to Derivium in 2001.[12] The court concluded that each factor except the sixth, dealing with property taxes, suggested a sale, not a loan.[13] The court stressed Derivium's receipt of unqualified possession and control of the property and concluded that the taxpayer "retained no property interest in the stock. At best he had an option to purchase an equivalent number of IBM shares after 3 years . . . ."[14]

The majority's reliance on the *Grodt & McKay* factors was criticized by two concurring opinions, both of which argued that *Grodt & McKay*, which addressed an alleged sale of tangible property, was a poor guide to transactions in financial instruments.[15] Judge Halpern filed a concurring opinion arguing the majority's reasoning was needlessly complex.[16] Halpern argued that tax ownership of securities is determined solely by the putative new owner's degree of control over the securities.[17] If the borrower had complete control over the securities, as Derivium did, then it should be treated as the tax owner, regardless of its degree of economic ownership.[18]

The second concurring opinion also sought a simpler basis for the court's decision. Judge Holmes argued that, even if the transaction was respected as a secured loan, general tax principles would require Calloway to recognize gain at the time the collateral was sold by Derivium.[19] Since the collateral was sold immediately, the tax results would be substantially the same as if the stock loan to Derivium were treated as a sale event.[20]

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11. *Id.* at 1237 (internal citations omitted).
12. *Calloway*, 135 T.C. at 34.
13. *Id.* at 34-36.
14. *Id.* at 35.
15. *Id.* at 49-50 (Halpern, J., concurring), 54-55 (Holmes, J., concurring).
16. *Id.* at 49 (Halpern, J., concurring).
17. *Id.* at 50-51 (Halpern, J., concurring). Judge Halpern cited *Provost v. United States*, 269 U.S. 443 (1926), and *Richardson v. Shaw*, 209 U.S. 365 (1908), which established possession and the right to sell as the two keys to establishing tax ownership of stock.
18. *Calloway*, 135 T.C. at 51 (Halpern, J., concurring).
19. *Id.* at 53 (Holmes, J., concurring).
20. *Id.* at 69.

B. Eleventh Circuit Opinion

The narrow legal question posed by *Calloway* is of relatively little interest. It was clear to most observers that the Derivium tax shelter, as structured, did not work to defer gain on appreciated securities.[21] The more significant element of the decision is how that conclusion should be reached. The opinions in the Tax Court presented three alternative grounds.[22] The Court of Appeals for the Eleventh Circuit accepted the majority's *Grodt & McKay* approach and rejected the two concurring theories.[23] However, the Eleventh Circuit also suggested that the *Grodt & McKay* test should be viewed through the prism of *Dunne v. Commissioner*,[24] a Tax Court case deciding which of two shareholders of an S corporation should take the corporation's income into account while ownership of the shares was under dispute.[25]

It is unclear whether the Eleventh Circuit is correct in viewing *Dunne* as a helpful refinement of the *Grodt & McKay* factors. Neither of the decisions in *Dunne* and *Anschutz v. Commissioner*,[26] which recently applied the *Dunne* factors to a deferred sale of stock, cited *Grodt & McKay*. Moreover, both of those cases involved transactions where it was conceded that a sale had occurred, and the only question was when tax ownership was transferred.[27]

A problem with both the *Grodt & McKay* and *Dunne* tests is that, despite offering lush lists of factors, they offer little actual guidance as to how a transaction should be analyzed. This is in part because many of the factors listed are irrelevant for most transactions.[28] A broader concern is that simply listing potentially relevant factors does little to illuminate how a court should weigh those factors. Obviously a transaction where every relevant factor points to a sale is a sale, and one where every factor indicates a loan is a loan. The interesting cases arise

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21. *See, e.g.*, Sam Young, *Tax Court Reached Right Decision in* Calloway *Despite Weak Reasoning, Practitioners Say*, TAX NOTES TODAY (July 12, 2010), *available at* LEXIS 2010 TNT 132-7.

22. *See Calloway*, 691 F.3d at 1327, 1332.

23. *Id.*

24. No. 24666-05, 2008 WL 656496 (T.C. Mar. 12, 2008).

25. *Calloway*, 691 F.3d at 1329.

26. 135 T.C. 78 (2010).

27. *See Dunne*, 2008 WL 656496, at *7; *Anschutz*, 135 T.C. at 98.

28. The *Grodt & McKay* factors include: property taxes; delivery of deeds; and risk of damage to the property. 77 T.C. at 1237-38. The *Dunne* factors include: right to participate in shareholder meetings; right to vote for directors; and right to inspect corporate books. 2008 WL 656496, at *11. Though these rights may be germane in the context of a close corporation, they have little relevance for most securities transactions.

where the factors are mixed. If a securities transaction is formally a sale, but the "seller" retains some exposure to the economics of the security (or vice versa), how should the transaction be taxed? A simple list stating that both the form and the economics are relevant does not help resolve this question.

The decisions in both the Eleventh Circuit and the Tax Court expressed a desire to avoid altering the treatment of common commercial transactions.[29] Many legitimate transactions involve transferring possession of, or an economic interest in, securities. Some such transactions, like stock loans, have their treatment codified by statute. The taxation of other transactions, such as repurchase agreements, is surprisingly uncertain, despite their ubiquity. A broadly worded opinion in *Calloway* could potentially have created uncertainty for such transactions. Fortunately, though the *Calloway* opinion purports to establish an explicit test for distinguishing sales from loans in the securities context, the vagueness of the multi-factor test should prevent the opinion from creating any real uncertainty for common transactions.

II. *SHOCKLEY V. COMMISSIONER*

Shockley v. Commissioner[30] addressed the question of when proceedings relating to a defective notice of deficiency will toll the statute of limitations.[31] The case arose from a tax deficiency asserted by the Service with respect to Shockley Communications Corp. (SCC) and its individual shareholders, Sandra and Terry Shockley, as transferees. In 2001, the Shockleys sold SCC, which was merged out of existence by the buyer.[32] The corporation filed a return for its short 2001 year in 2002. The Service audited SCC's 2001 return. In 2004, the Service requested an extension of the statute of limitations from the Shockleys, in their capacity as officers of the corporation, but the Shockleys informed the Service that they were no longer officers of SCC and identified the successor-in-interest of SCC.[33]

29. *See Calloway*, 691 F.3d at 1332; *Calloway*, 135 T.C. at 69 (Holmes, J., concurring).
30. 686 F.3d 1228 (11th Cir. 2012).
31. *Id.* at 1230.
32. *Id.* It appears the underlying transaction was a "Midco" transaction in which, as part of a prearranged plan, the acquirer liquidated SCC and immediately sold a portion of its assets to another party. Shockley v. Comm'r, No. 28210-08, 2011 WL 1641884, at *2 (T.C. May 2, 2011). The substance of the deficiency asserted by the Service was that SCC recognized gain on the sale of its assets. *Id.* at *12. Midco transactions are listed transactions. I.R.S. Notice 2008-111, 2008-51 I.R.B. 1299.
33. *Shockley*, 686 F.3d at 1230.

In 2005, the Service issued two notices of deficiency. One was mailed to the address provided on SCC's return. The second was sent to the Shockleys' personal address. Both listed SCC as the taxpayer. The Shockleys filed a protective Tax Court petition with respect to the second notice, asserting that the notice was invalid with respect to SCC. The first notice, which was sent to the corporation's last known address, was conceded to be valid. Likewise, the second notice, which was sent to the address of the shareholders, was conceded to be invalid.[34] The ultimate issue was whether the petition filed with respect to the invalid notice sufficed to extend the statute of limitations.[35]

A. *Background*

Before a tax can be collected, it must be assessed.[36] Before an income tax can be assessed, the Service must issue a statutory notice of deficiency.[37] Once a notice of deficiency is issued, the taxpayer has ninety days to file a petition in the Tax Court.[38] The Service may assess the tax after the ninety-day period passes or, if a petition is filed, after the Tax Court's decision becomes final.[39]

For assessment of income taxes, the statute of limitations is typically three years from the date of filing of the tax return (or, if later, the due date for the return).[40] The statute of limitations period is tolled during the ninety-day period after the issuance of a statutory notice, during the pendency of any Tax Court litigation, and for sixty days after the end of those periods.[41]

Once a tax is assessed against a taxpayer, transferee liability can be asserted against certain transferees. The Service has one year after the expiration of the statute of limitations for the primary tax to issue notices of transferee liability.[42]

SCC filed its 2001 return in February 2002. Thus, the three-year statute of limitations would expire in February 2005. The Service mailed two timely notices of deficiency. The notice of deficiency with respect to SCC was uncontested, so absent the second notice, the statute of limitations would have been extended by only 150 days, to July 2005.

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34. *Id.* at 1230-35.
35. *Id.* at 1230.
36. I.R.C. § 6501(a) (2006).
37. I.R.C. § 6213(a) (2006).
38. *Id.*
39. *Id.*
40. I.R.C. § 6501(a).
41. I.R.C. § 6503(a)(1) (2006).
42. I.R.C. § 6901(c) (2006).

Since the Service did not assess the tax during this period, the taxpayer argued that the assessment was time-barred.[43]

However, Section 6503(a)(1) of the Internal Revenue Code[44] provides that the statute of limitations is tolled during the pendency of any petition for a redetermination of the deficiency in the Tax Court.[45] Thus, if the petition filed by the Shockleys is taken into account, the statute of limitations would have been extended until the Shockleys' petition was ultimately dismissed.[46]

The Tax Court ruled in favor of the taxpayers.[47] The court distinguished two earlier cases that held a petition filed by an individual who lacked capacity to act on behalf of the taxpayer was still effective to toll the statute of limitations.[48] In the Tax Court's view, the critical distinction was that the Shockleys' petition noted on its face that it disputed the validity of the underlying notice of deficiency.[49] Thus, it was not reasonable for the Service to rely on the petition, as it would be if the petition did not explicitly allege an underlying defect.[50]

B. *Eleventh Circuit Decision*

The Eleventh Circuit overturned the decision of the Tax Court and held that the Service's assessment of the tax was timely.[51] Relying primarily on the plain language of the statute, which was found to be unambiguous,[52] the court held that § 6503(a)(1) creates a "mechanical,

43. *Shockley*, 2011 WL 1641884, at *2-3.

44. I.R.C. § 6503(a)(1) (2006).

45. *Id.*

46. *Shockley*, 2011 WL 1641884, at *5.

47. *Id.* at *9.

48. *Id.* at *8-9.

49. *Id.* at *9.

50. *Id.* The Tax Court also cited *Greve v. Commissioner*, 42 B.T.A. 142 (1940), in which the Board of Tax Appeals held that an invalid notice which prompted the taxpayer to file a petition did not result in a suspension of the statute of limitations. *Id.* at 145. However, in *Greve*, the statute of limitations lapsed in the period between the mailing of the invalid notice and the filing of the petition. *Id.* In *Shockley*, the statute was extended by the valid notice sent to SCC. 2011 WL 1641884, at *6.

51. *Shockley*, 686 F.3d at 1239.

52. The court also attempted to draw a distinction between § 6503(a)(1), which tolls the statute of limitations "if a proceeding in respect of the deficiency is placed on the docket of the Tax Court," and § 6213, which allegedly "create[s] a specific statutory suspension when the 'taxpayer' files a 'petition' for 'redetermination of' the deficiency." I.R.C. § 6503(a)(1); *Shockley*, 686 F.3d at 1236. In the court's view, this distinction suggested that § 6503(a)(1) was intended to be broader than § 6213. *Id.* Leaving aside the question of whether it is plausible to suggest that Congress intended to create subtle differences between cases that restrict the Service's assessment of taxes and those that suspend the statute of limitations, the court's comparison is factually incorrect. Section 6213(a)

bright-line test."[53] Any proceeding placed on the Tax Court docket relating to a deficiency suspends the statute of limitations for assessment of that deficiency.[54] Because the Shockleys' petition was filed in response to a notice of deficiency that clearly described SCC's corporate deficiency (even though it was mailed to the Shockleys as individuals), it operated to toll the limitations period.[55]

The court also disputed the Tax Court's conclusion that the Shockleys did not purport to file their petition on behalf of SCC.[56] The Eleventh Circuit noted that SCC was listed on the petition as the petitioner, and the petition stated that it was "filed on behalf of [SCC] subject to the invalidity of the Notice of Deficiency and the failure to properly serve the corporation."[57] The court was also concerned that disregarding the Shockleys' petition for statute of limitations purposes would create a "Hobson's choice" for the Service when a petition challenging a notice of deficiency was filed: either assess the tax, which would violate § 6213 if the notice is upheld, or do nothing, and be unable to assess the tax later if the notice is invalid.[58]

The Eleventh Circuit's decision creates considerable uncertainty for taxpayers who receive a notice of deficiency that may be invalid. Litigating the deficiency on its merits is probably unwise. If the notice turns out to be invalid, the Tax Court lacks jurisdiction, so any favorable judgment cannot be relied on. Moreover, the litigation will extend the Service's statute of limitations to issue a valid notice. Filing a protective petition to challenge the validity of the notice is also problematic after *Shockley* because it gives the Service more time to issue a new notice of deficiency.[59] The final option is to simply do nothing in response to the notice. Though this option does not extend the statute of limitations for the Service, if the notice is valid, taxpayers may have forfeited their only opportunity to challenge the validity of the Service's determination without paying the tax.

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restricts assessment of a tax "if a petition has been filed with the Tax Court." I.R.C. § 6213(a). The more specific language cited by the court is used to explain that a taxpayer may file a petition to request a redetermination of a deficiency.

53. *Shockley*, 686 F.3d at 1236.

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.* at 1231.

58. *Id.* at 1236.

59. *See id.* (stating § 6503(a)(1) must be read in favor of the government and thus the 2005 petition suspended the statute of limitations).

The opinion in *Shockley* has been criticized by some commentators.[60] The United States Court of Appeals for the Ninth Circuit recently affirmed the principle that a petition filed to contest an invalid notice does not extend the statute of limitations.[61] Moreover, the same principle was adopted by the Service in Rev. Ruling 88-88.[62] In that ruling, the Service considered the consequences of mistakenly issuing a notice of deficiency when the taxpayer had already filed a Tax Court petition for that year.[63] Such a notice is invalid, and, the Service reasoned, "[b]ecause such a notice is invalid, the filing of a Tax Court petition with respect to it does not stop the running of the period of limitations under section 6503(a) of the Code within which the Service may correct this error and summarily assess the tax."[64]

III. *G.D. PARKER, INC. V. COMMISSIONER*

A. *Background*

In *G.D. Parker, Inc. v. Commissioner*,[65] the taxpayer (GDPI) was a U.S. corporation owned by a Peruvian resident (G.D. Parker) through a chain of foreign holding corporations. Through 2003, GDPI was in the business of operating marinas through one of its consolidated subsidiaries. In 2003, the marina business was sold in an installment sale, with the bulk of the consideration to be paid in 2004.[66]

The direct parent of GDPI was Vilanova, S.A., a Panamanian corporation that also owned a two-percent stake in a Peruvian telecommunications company, Tele2000, S.A. Tele2000 was originally founded by Parker, but the remaining ninety-eight percent of its shares had since been acquired by BellSouth. Parker and BellSouth were engaged in various lawsuits and disputes relating to the acquisition. By 2004, Vilanova's basis in its Tele2000 stock exceeded its fair market value by a factor of approximately 100.[67]

In March 2004, BellSouth signed an agreement to sell its Tele2000 stock to Telefonica, a Spanish media conglomerate. As part of the sale

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60. *See* Andy R. Roberson & Kevin Spencer, *11th Circuit Allows Invalid Notice to Suspend Assessment Period*, TAX NOTES TODAY (Aug. 8, 2012), *available at* LEXIS 2012 TNT 153-3.

61. Napoliello v. Comm'r, 655 F.3d 1060 (9th Cir. 2011).

62. Rev. Rul. 88-88, 1988-2 C.B. 354.

63. *Id.*

64. *Id.*

65. No. 20280-06L, 2012 WL 5935661 (Nov. 27, 2012).

66. *Id.* at *1, *3.

67. *Id.* at *4-5, *7.

agreement, BellSouth indemnified Telefonica against the risk of having to pay more than a stated amount to Vilanova to acquire the remaining outstanding shares.[68] A sale at the stated amount would produce a capital loss to Vilanova.

The 2004 installment payment on GDPI's marina sale was expected to produce considerable gain. To offset this gain, Vilanova contributed its Tele2000 stock to GDPI in September 2004, settled its various disputes with BellSouth, and, in December, caused GDPI to sell the Tele2000 stock to Telefonica at the requested price. The consideration for the Tele2000 stock was paid directly to Parker. The Service challenged GDPI's claimed capital loss.[69]

B. *Analysis*

The particular tax avoidance transaction at issue in *G.D. Parker* is no longer viable because of Section 362(e) of the Internal Revenue Code,[70] which requires a corporation "import[ing]" a built-in loss from a foreign shareholder to write down its basis in the asset.[71] If § 362(e) applied, GDPI's basis in the Tele2000 stock would have been reduced to fair market value.[72]

Though the Service argued that § 362(e)—which was enacted shortly before the transaction at issue—applied, the Tax Court's decision was based on the step-transaction doctrine.[73] The court applied the most expansive formulation of the step-transaction doctrine: the end-result test.[74] Under this formulation, a court will disregard an intermediate step in a transaction if the step is part of a single transaction intended to achieve a particular end result.[75] Once the decision was made to apply the end-result test, the conclusion that the contribution of the Tele2000 shares to GDPI should be disregarded was a foregone conclusion. The taxpayer was unable to offer any serious business reason for the contribution of the shares to GDPI.[76] Given the close proximity of the contribution of the shares and their sale, it was very clear to the court that the sale was the intended end result.[77]

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68. *Id.* at *8.
69. *Id.* at *3, *8.
70. I.R.C. § 362(e) (2006).
71. *Id.*
72. *G.D. Parker*, 2012 WL 5935661, at *13.
73. *Id.* at *10-11.
74. *Id.* at *11.
75. *Id.* at *12.
76. *Id.*
77. *Id.*

It is possible that a significant factor in the court's decision was the fact that the sales price for the Tele2000 shares was paid directly to Parker, not to GDPI, the normal seller. Given that the Tele2000 stock was nearly worthless, the payment of the consideration would seem to be relatively insignificant. The Tax Court's opinion does not give much explicit weight to this factor. However, it is possible that the parties' failure to respect this aspect of their desired form was fatal. As the transaction actually happened, the taxpayer was arguing for a four-step construction: (1) Vilanova contributes Tele2000 shares to GDPI; (2) GDPI sells shares to BellSouth, recognizing a capital loss; (3) GDPI distributes proceeds to Vilanova; and (4) Vilanova distributes proceeds to Parker. By contrast, the Service's recast of the transaction only involved two steps: (1) Vilanova sells the Tele2000 shares to BellSouth, recognizing the loss; and (2) Vilanova distributes the proceeds to Parker.[78]

As the transaction actually happened, the Service's recast is considerably more direct. Vilanova's contribution of shares and GDPI's distribution of cash create a circular flow, making it relatively simple for the Tax Court to collapse the two steps. On the other hand, if GDPI had received and retained the proceeds, the taxpayer's view of the transaction would have two steps: (1) Vilanova contributes Tele2000 shares to GDPI; and (2) GDPI sells shares to BellSouth, recognizing a capital loss. The Service's desired recast would be no simpler: (1) Vilanova sells the Tele2000 shares to BellSouth, recognizing the loss; and (2) Vilanova contributes the proceeds to GDPI. In this hypothetical case, the Service would be reordering steps, rather than collapsing multiple steps into one. Some cases have refused to apply the step-transaction doctrine in such situations.[79]

Even if the transaction had survived step-transaction scrutiny, the Tax Court arguably should have disallowed GDPI's claimed loss under Section 482 of the Internal Revenue Code[80] or the *Court Holding* doctrine.[81] Section 482 permits the Commissioner to reallocate income between entities under common control as needed to clearly reflect income.[82] The *Court Holding* doctrine developed at a time when corporate liquidations followed by shareholder sales of assets were treated more favorably than direct corporate sales. As a result, some

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78. *Id.* at *21, *25.

79. *See, e.g.*, Esmark, Inc. v. Comm'r, 90 T.C. 171 (1988).

80. I.R.C. § 482 (2006).

81. *See* Comm'r v. Court Holding Co., 324 U.S. 331 (1945). The Service advanced these arguments in its notice of deficiency. *G. D. Parker*, 2012 WL 5935661, at *9.

82. I.R.C. § 482.

taxpayers would negotiate a sale at the corporate level, then purport to liquidate the corporation and have the shareholders sell the assets. In cases where the transaction was agreed in substance at the corporate level, the *Court Holding* doctrine provided that the corporation should be treated as the true seller, with the attendant tax consequences. Under both § 482 and *Court Holding*, the contribution of the Tele2000 stock appears dubious. It appears that the relevant terms of the sale of stock were agreed to before the stock was contributed to GDPI.