A Tax Opinion that Didn't Carry the Day.

Although Congress codified the economic substance doctrine, courts continue to deal with an inventory of cases applying the doctrine under existing precedent. On June 24th, the Fifth Circuit decided an interesting one, *Nevada Partners Fund, L.L.C. v. United States,* 2013 U.S. App. LEXIS 12877 (June 24, 2013).

Nevada Partners involved a tax shelter that was driven by foreign currency transactions. The multi-tiered structure, as described by the Court, worked like this:

- First, the investment manager established a group of LLCs. These included an LLC which would act as a holding company for two others. This first-tier LLC would be formed with a transitory partner and it would own 99% of a second LLC, which in turn would own 99% of a third LLC. Initially, the transitory partner would own a 99% interest in the first-tier LLC, and the promoter, Bricolage, would own 1%. *Id.,* slip op. at *7.
- Next, the two lower tiered LLCs created the desired tax loss; the third-tier LLC entered into currency forward contracts producing offsetting gains and losses through straddles. The gains would be realized and reported as income by the 99% transitory partner; while the losses in the other legs would be suspended in the books of the third-tier LLC. *Id.,* slip op. at *7.
- Then the investor, who was seeking tax benefits, would purchase the transitory partner's interest in the LLCs. To give the investor sufficient basis to take advantage of the embedded losses, the second-tier LLC obtained a loan guaranteed by the investor that would be used to engage in a limited risk foreign currency transaction known as a carry trade. *Id.,* slip op. at *7-*8. The transaction, which involved the Japanese Yen, was the subject of collar that limited the investor's potential loss to approximately $90,000 and its potential gain to about $77,000. *Id.,* slip op. at *17-*18. Despite this limited risk, the investor guaranteed a $9 million bank loan to the second-tier LLC. *Id.*, slip op. at *18.

The Fifth Circuit examined the transaction using its traditional three factor test, which requires that a transaction "exhibit objective economic reality, a subjectively genuine business purpose, and some motivation other than tax avoidance." *Id.,* slip op. at 34 (citing *Southgate Master Fund LLC ex rel. Montgomery Capital Advisors LLC v. United States,* 659 F.3d 466, 480 (5th Cir. 2011)). Applying this test, the Court quickly concluded that the district court properly determined that the transaction lacked economic substance.

The more interesting aspect of the opinion (at least for me) is the penalty discussion, which involved the negligence penalty under Section 6662 of the Code and the good faith defense under Section 6664(c)(1) of the Code. First, the Court of Appeals sustained the negligence penalty, ruling that the evidence supported the district court's determination that "persons acting in behalf of the partnerships knew" that the relevant transactions lacked economic substance. *Id.* at *54. The court also noted that the promotion of the partnerships continued despite an IRS notice had warned against partnership straddle tax shelters. *Id.* at *55.

Turning to the good faith defense, the Court of Appeals considered a series of cases cited as support for the defense. These were rejected as distinguishable because the cases had involved transactions with a reasonable possibility of meaningful profit or loss. *Id.* at *57-*58. More significantly, the Court held that tax opinions provided by Arnold & Porter was insufficient to support a defense because the opinions did not sufficiently address the details of the transaction that the court considered problematic and were premised upon a representation that the transaction was being pursued for profit motives, not tax losses when the record was to the contrary. *Id.*, slip op. at *64-*66.

There is one aspect of this analysis that I find troubling: the Court's determination apparently applies a clearly erroneous standard to the question whether the Arnold & Porter opinion was sufficient to support a reasonable reliance defense. While it probably didn't make a difference here, given the apparent strength of the record on the tax motivation for the transaction, I could certainly foresee a situation where treating the question whether an attorney's tax opinion sufficiently addressed the relevant facts of a transaction as a "fact issue" could yield an inappropriate result. After all, the sufficiency of the fact discussion in a tax opinion calls for a court to apply regulations to a factual record, and that is a context where appellate courts typically don't defer to district judges.

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