

FCG VALUATION CASE E-FLASH

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Carlos E. SALA; Tina Zanolini-Sala, Plaintiffs-Appellees, v. United States of America, Defendant-Appellant.
No. 08-1333

United States Court of Appeals, 10th Circuit. July 23, 2010. No. 08-1333

Carlos Sala invested in an investment program, the first stage of which was designed to generate significant tax losses without significant economic losses. The program relied on *Helmer v. Commissioner*, 34 TCM (CCH) 727 (1975), which disregarded the value of contingent liabilities in calculating a partner's basis in the partnership interest. A district court determined that the subject investment program taken as a whole consisted of a legitimate business strategy and allowed the tax loss. The government appealed the district court's ruling.

TAKEAWAY:

Careful review of case law other than *Helmer* would have caused Sala to look for additional ways to offset his 2000 income. The initial phase of the investment program was designed specifically to generate tax losses, which directly contradicts IRS Notice 2000-44 (issued before Sala's investment in Deerhurst) and forbids noneconomic losses to be taken as allowable deductions. Blind reliance on prior rulings without consideration of other court cases and additional factors related to the entity at hand can lead to undesirable outcomes.

INVESTMENT PROGRAM GENERATES TAX LOSSES WITHOUT ECONOMIC LOSSES

In 2000, Carlos Sala received more than \$60 million in income, primarily from exercised stock options. Recognizing the significance of the tax liability associated with \$60 million of income, Mr. Sala looked to offset some or all the income. Mr. Sala invested in the Deerhurst Program (the "Program"), which used the ruling in *Helmer* to generate tax losses without generating economic losses.

The Program required investors to acquire long and short foreign currency options. These options were contributed to the Deerhurst Investors, GP (the "Partnership" or "Investors"). Using the rule in *Helmer*, only the value of the long options would be used to calculate the partner's basis in the partnership. Accordingly, upon liquidation of the Partnership, Sala's basis in the partnership would be much larger than the value realized after liquidation, generating a tax loss while minimizing the possibility of an economic loss.

Sala deposited approximately \$9 million in an account managed by the Program before November 21, 2000. Deerhurst's management then used this contribution to purchase long options worth just under \$61 million if exercised and short options worth just over \$60 million if exercised plus a transaction fee of approximately \$700,000. The value of the long and short options essentially offset each other.

One week later, these options and approximately \$8 million in cash were transferred to Investors (through Sala's wholly owned S corporation "Solid") in exchange for a partnership interest. Applying the *Helmer* rule, Solid calculated its basis and disregarded the short options. As a result, Solid's basis was calculated at approximately \$69 million (\$61 million in long options and \$8 million in cash).

Between November 28 and December 31, 2000, the options were sold for a profit between \$90,000 and \$110,000 and the Partnership was liquidated. Solid received \$8 million in cash and two foreign currency contracts. Solid received less than \$1 million upon the sale of those foreign currency contracts. With a \$69 million basis and receipt of less than \$9 million upon liquidation of the general partnership, Solid claimed a loss of more than \$60,250,000.

Solid's loss, however, was entirely artificial. In fact, Solid actually realized a gain from its investment in Investors. Additionally, because the Partnership was profitable, participants in the program were required to reinvest their proceeds with Deerhurst Trading LLC for at least five years or face significant penalty. Sala complied with the terms of the program and Deerhurst Trading LLC managed his reinvested funds through 2004.

Sala initially claimed the entire \$60 million loss on his tax return. In November 2003, he amended his tax return for 2000, did not claim the \$60 million loss, and paid approximately \$26 million in taxes, interest, and penalties. Ten months later, Sala filed another 1040X in which he again claimed the \$60 million deduction and requested a refund of more than \$23.7 million. The IRS disallowed the refund and Sala challenged the IRS position.

INVESTMENT PROGRAM LACKS ECONOMIC SUBSTANCE

The government believed Sala's transaction in Deerhurst Investors GP lacked economic substance. As a result, his claimed tax loss was not allowable.

Sala did not contest that the loss was fictional. However, he maintained that the *Helmer* ruling controlled for his calculation of basis, and Sala believed he was entitled to the deduction.

The district court which initially handled the case believed that the Deerhurst Program had to be viewed as a single transaction. The Appellate Court disagreed and relied on *James v. Commissioner*, 899 F.2d 910 (10th Circuit 1990), which determined that some pieces of a transaction "cannot be legitimized merely because [it was] on the periphery of some legitimate transactions." The Appellate Court further found that transactions in the Deerhurst Program after 2000 had no relevance to the tax loss claimed in 2000.

Having determined it could look solely at the Deerhurst Investors GP transaction, the Appellate Court then relied on *Jackson v. Commissioner* 966 F.2d (10th Circuit 1992), *Keeler v. Commissioner* F.3d (10th Circuit 2001), *Coltec Industries, Inc. v. United States*, 454 F.3d (Fed Circuit 2006), and *Rogers v. United States* 281 F.3d (10th Circuit 2002) to determine that a transaction used for tax loss purposes must have basis in economic reality and be linked to actual losses.

COURT RULES IN FAVOR OF GOVERNMENT

The Appellate Court determined that Sala benefited from his investment in Deerhurst Investors GP (as evidenced by his continued investment with Deerhurst Trading LLC). Additionally, the predetermined nature of the liquidation of Deerhurst Investors GP indicated a lack of economic substance to the Court. Because the transaction lacked economic substance, the Appellate Court reversed and remanded the district court's ruling and found in favor of the Appellant.

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