Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Associate Area Counsel (Newark 2)
(Large and Mid-Size Business)
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subject: Application of I.R.C. §§ 6011 and 6707A

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

FACTS

You requested advice on the application of § 6011 to factual scenarios involving taxpayers who entered into Distressed Asset Trust (DAT) transactions in 2005. The DAT transaction, identified as a listed transaction in Notice 2008-34, 2008-12 I.R.B. 645, was released to the public on February 27, 2008.

In a DAT transaction, the tax-indifferent party, directly or indirectly through a related entity such as a partnership, transfers assets having little or no fair market value ("FMV") with a purported high tax basis ("distressed assets") to a trust ("main-trust"). The parties to the transaction treat the transfer of distressed assets as a non-taxable contribution to the trust. The tax-indifferent party, or related entity, is described as the grantor and beneficiary of main-trust. Main-trust relies on § 1015(b) to claim basis in the distressed assets equal to that of the contributing party, which is alleged to be the original face value (debt) or the purported high tax basis (assets). Shortly thereafter, under the main-trust agreement, the trustee of main-trust creates a sub-trust to which the distressed assets in the main-trust are allocated. The main-trust agreement further provides that a sub-trust for a beneficiary constitutes a separate and distinct sub-trust of

main-trust, with beneficial interest certificates issued and separate records maintained for the sub-trust.

For purposes of this advice, we assume a U.S. taxpayer enters the transaction in 2005 by transferring $50,000 to main-trust, a simple trust, in exchange for an interest in the trust. Twenty thousand dollars of that amount was paid by the main-trust to the promoter as a fee and the remaining $30,000 was paid out in trustee fees and in transfers to the partnership that contributed the distressed assets to the main-trust. The amount of the cash transferred to main-trust equals the purported FMV of the distressed assets, plus fees. The U.S. taxpayer's cash investment, and economic stake, in the distressed assets is equal to a fraction of the claimed tax basis in the distressed assets. Following the investment of the U.S. taxpayer in the trust, the main-trust allocates distressed assets to the newly formed sub-trust. The U.S. taxpayer is given powers sufficient to be deemed owner of the sub-trust under § 678, such that the tax attributes of the sub-trust are taken into account by the U.S. taxpayer under § 671.

In the DAT transactions in which the distressed assets are debt instruments, the sub-trust declares the debt worthless at the close of that taxable year, usually within a few weeks of entering the transaction. Consequently, the sub-trust reports a business bad debt deduction under § 166 in an amount nearly equal to the claimed high tax basis. (In another version, the sub-trust sells the distressed assets to a third party or the U.S. taxpayer sells interests in the trust to a third party for FMV, incurring a loss deductible under § 165.)

The tax benefit to the U.S. taxpayer results from the § 166 deduction nearly equal to the claimed transferred high basis in the debt rather than an amount related to the reduction in value of the debt. Thus the claimed loss substantially exceeds the U.S. taxpayer's cash investment and economic stake.

The trustee of the sub-trust, a grantor trust, filed on behalf of the sub-trust a Form 1041, U.S. Income Tax Return for Estates and Trusts, that included a Grantor Information Statement that reflects a small legal fee and fiduciary fee, and a $900,000 bad debt deduction. Taxpayer is the grantor of sub-trust. At no time did the taxpayer or sub-trust file a Form 8886, Reportable Transaction Disclosure Statement, or send a copy of Form 8886 to the Office of Tax Shelter Analysis ("OTSA").

ISSUES

1. Whether the taxpayer participated in the DAT transaction in 2005 under § 1.6011-4 if the taxpayer deducted a loss of $50,000 in the trust section of Schedule E of the taxpayer's Form 1040, limiting the loss reported on the Grantor Information Statement to the taxpayer's basis and amount at risk in the investment.

2. Whether the taxpayer participated in the DAT transaction in 2005 under § 1.6011-4 if the taxpayer deducted a loss of $50,000 as a loss on Schedule A, Schedule D, or Schedule E of the taxpayer's Form 1040 resulting from a loss on a bad investment.

3. Whether the taxpayer and sub-trust participated in the DAT transaction in 2005 under § 1.6011-4 if the taxpayer did not claim any loss on the taxpayer's Form 1040 for the 2005 taxable year.

CONCLUSIONS

1. The taxpayer participated in the DAT transaction in 2005, because the taxpayer's Form 1040 reflected the tax consequences or tax strategy described in Notice 2008-34. Because the transaction was not identified as a listed transaction before the filing of the 2005 tax return, the taxpayer did not have to disclose the transaction under § 1.6011-4 at that time. The disclosure obligation arose after the transaction was identified as a listed transaction on February 27, 2008.

2. The taxpayer participated in the DAT transaction in 2005, because the taxpayer's Form 1040 reflected the tax consequences or tax strategy described in Notice 2008-34. Because the transaction was not identified as a listed transaction before the filing of the 2005 tax return, the taxpayer did not have to disclose the transaction under § 1.6011-4 at that time. The disclosure obligation arose after the transaction was identified as a listed transaction on February 27, 2008.

3. The taxpayer did not participate in the DAT transaction in 2005, because the taxpayer's Form 1040 did not reflect the tax consequences or tax strategy described in Notice 2008-34. The sub-trust participated in the DAT transaction in 2005, because the sub-trust's Form 1041, which included the Grantor Information Statement, reflected the tax consequences or tax strategy described in Notice 2008-34.

LAW

The regulations that are applicable to the present case are § 1.6011-4 as modified by TD 9108, 68 FR 75128 or as modified by TD 9295, 71 FR 64458. Treasury Decision 9108 and TD 9295 are effective for transactions entered into on or after December 29, 2003, but taxpayers may rely on these regulations for transactions entered into on or after January 1, 2003, and before December 29, 2003.

Treas. Reg. § 1.6011-4(a) provides that every taxpayer that has participated, as described in § 1.6011-4(c)(3), in a reportable transaction within the meaning of § 1.6011-4(b) and who is required to file a tax return must attach to its return for the taxable year described in § 1.6011-4(e) a disclosure statement in the form prescribed by §1.6011-4(d).

Treas. Reg. § 1.6011-4(b) provides that a reportable transaction is a transaction described in § 1.6011-4(b)(2) through (7). The term transaction includes all of the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement, and includes any series of steps carried out as part of a plan.

Treas. Reg. § 1.6011-4(b)(2) provides that a listed transaction is a transaction that is the same as or substantially similar to one of the types of transactions that the Internal Revenue Service (IRS) has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction.

Treas. Reg. § 1.6011-4(c)(1) provides that the term "taxpayer" means any person described in § 7701(a)(1), including S corporations. The term "taxpayer" also includes, unless specifically provided elsewhere in § 1.6011-4, an affiliated group of corporations that joins in the filing of a consolidated return under § 1501.

Treas. Reg. § 1.6011-4(c)(3)(i)(A) provides that a taxpayer has participated in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in the published guidance that lists the transaction under § 1.6011-4(b)(2). A taxpayer also has participated in a listed transaction if the taxpayer knows or has reason to know that the taxpayer's tax benefits are derived directly or indirectly from tax consequences or a tax strategy described in published guidance that lists a transaction under § 1.6011-4(b)(2). Published guidance may identify other types or classes of persons that will be treated as participants in a listed transaction.

Treas. Reg. § 1.6011-4(c)(7) defines the term tax return as a Federal income tax return and a Federal information return.

Treas. Reg. § 1.6011-4(e)(1) provides that the disclosure statement for a reportable transaction, Form 8886 "Reportable Transaction Disclosure Statement" (or successor form), must be attached to the taxpayer's tax return for each taxable year for which a taxpayer participates in a reportable transaction. In addition, the disclosure statement for a reportable transaction must be attached to each amended return that reflects a taxpayer's participation in a reportable transaction. A copy of the disclosure statement must be sent to OTSA at the same time that any disclosure statement is first filed by the taxpayer.

Treas. Reg. § 1.6011-4(e)(2)(i) provides that if a transaction becomes a listed transaction after the filing of a taxpayer's tax return (including an amended return) reflecting either tax consequences or a tax strategy described in the published guidance listing the transaction (or a tax benefit derived from tax consequences or a tax strategy described in the published guidance listing the transaction) and before the end of the period of limitations for the final return (whether or not already filed) reflecting the tax consequences, tax strategy, or tax benefit, then a disclosure statement must be filed as

an attachment to the taxpayer's tax return next filed after the date the transaction is listed regardless of whether the taxpayer participated in the transaction in that year.

Treas. Reg. § 1.671-4(a) provides that except as otherwise provided in § 1.671-4(b) and § 1.671-5, items of income, deduction, and credit attributable to any portion of a trust that, under the provisions of subpart E (§ 671 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code, is treated as owned by the grantor or another person, are not reported by the trust on Form 1041, "U.S. Income Tax Return for Estates and Trusts," but are shown on a separate statement to be attached to that form.

Treas. Reg. § 1.671-4(b)(1) provides that in the case of a trust all of which is treated as owned by one or more grantors or other persons, and which is not described in § 1.671-4(b)(6) or (7), the trustee may, but is not required to, report by one of the methods described in § 1.671-4(b) rather than by the method described in § 1.671-4(a).

Treas. Reg. § 1.671-4(b)(2)(i)(A) provides that the trustee must furnish certain information of the grantor to all payors and certain information to the grantor, but that the trustee is not required to file any type of return with the Internal Revenue Service.

Treas. Reg. § 1.671-4(b)(6) provides that certain trusts cannot use the methods of reporting described in § 1.671-4(b), including a trust that has its situs or any of its assets located outside the United States.

Treas. Reg. § 1.671-4(b)(7) generally provides that certain trusts cannot use the methods of reporting described in § 1.671-4(b) if a grantor is an exempt recipient for information reporting purposes.

Section 7701(a)(1) provides that the term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.

In Notice 2008-34 the Service identified transactions that are the same as, or substantially similar to, the transaction described in Notice 2008-34 that are entered into after October 22, 2004, as "listed transactions" for purposes of Treas. Reg. § 1.6011-4(b)(2) and §§ 6111 and 6112, effective February 27, 2008, the date the notice was released to the public.

ANALYSIS

Under § 1.6011-4(a), a taxpayer that has participated in a reportable transaction and who is required to file a tax return must disclose the transaction. At the time the 2005 return was filed, Notice 2008-34 had not been released, therefore, the transaction in this case was not yet a listed transaction and was not subject to the disclosure rules under §1.6011-4 when the 2005 return was filed. However, in 2008, the transaction was identified as a listed transaction.

A taxpayer participates in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in the published guidance that lists the transaction. If the taxpayer decides to take a deduction only to the extent of his actual economic outlay, he has still engaged in the transaction and is reflecting the tax consequences and/or tax strategy from the transaction. In the factual scenarios in which the taxpayer has claimed any amount of the deduction on his tax return, the taxpayer has reflected the tax consequences and tax strategy of the Notice 2008-34 transaction. The Schedule on which the deduction was claimed is not relevant for purposes of §1.6011-4.

Consequently, in the first two factual scenarios, the taxpayer has participated in the DAT transaction under § 1.6011-4 in 2005. In the third scenario, the taxpayer did not claim any loss from the transaction. Assuming the taxpayer claimed no other tax consequences from the transaction and the tax strategy of the transaction is not reflected on the return in any manner, it appears that the taxpayer did not participate in the transaction under § 1.6011-4 in 2005.

A grantor trust may report by the method provided in § 1.671-4(a) or (b). Grantor trusts that choose to report by the method provided in § 1.671-4(b) are not required to file a Federal income tax return or Federal information return, and, therefore, would not have a disclosure obligation under § 1.6011-4. However, a grantor trust described in § 1.671-4(b)(6) or (7) must report by the method provided in § 1.671-4(a). In this case, the sub-trust reported by the method provided in § 1.671-4(a). The Grantor Information Statement attached to the sub-trust's Form 1041 reflected a business bad debt deduction of $900,000, even though the sub-trust and grantor did not claim the deduction. This is a reflection of the tax consequences and tax strategy on the sub-trust's Federal information return which was required to be filed under § 1.671-4(a). Therefore, the sub-trust participated in the DAT transaction under § 1.6011-4 in 2005.

Hazards of Litigation

In situations where a grantor trust is required to report by the method described in § 1.671-4(a), the taxpayer for purposes of § 1.6011-4 is the grantor trust, not the trustee. Therefore, the grantor trust, and consequently the grantor, would be subject to the penalty under § 6707A for failure to properly disclose the transaction in accordance with § 1.6011-4. [redacted]

Please call if you have any further questions.