

MEMORANDUM

Pursuant to requirements related to practice before the Internal Revenue Service, any tax advice contained in this communication (including any attachments) is not intended to be used and cannot be used, for purposes of (i) avoiding penalties imposed under the United States Internal Revenue Code or (ii) promoting, marketing or recommending to another person any tax related matter.

This memorandum addresses the recent Internal Revenue Service Notice concerning investments involving trusts and distressed assets, and discusses the necessary steps to comply with the recent developments.

On February 27, 2008, the Internal Revenue Service issued Notice 2008-34. This Notice identified transactions involving the use of distressed asset trusts, and substantially similar transactions, as “listed transactions” for purposes of Treasury Regulation § 1.6011-4(b)(2).

A “listed transaction” is a transaction which is the same as or substantially similar to a transaction which has been identified by the IRS as a type of tax avoidance transaction. Listed transactions are not necessarily in violation of the tax code; rather, they are transactions in which the IRS has expressed a belief that the primary purpose is to reduce or eliminate taxes that would otherwise be due and collected. Listed transactions are sometimes also referred to by the IRS as “tax shelters.”

Transaction fact pattern and treatment

The IRS describes a distressed asset trust transaction as one in which a party not subject to U.S. taxation contributes distressed assets with a high basis and low fair market value to a trust. A U.S. taxpayer then acquires an interest in the trust by transferring cash or a note to the trust. The amount of cash or the note is approximately equal to the fair market value of the distressed assets. Upon such transfer, the taxpayer becomes a beneficiary of the trust.

The IRS asserts that the trust is considered by the parties to be a trust for tax purposes and thus the trust’s tax basis in the distressed assets is identical to the tax-indifferent granting party’s tax basis in the distressed assets. The trust then creates a sub-trust for the benefit of the Taxpayer and transfers the distressed assets to the sub-trust. The taxpayer treats the sub-trust as a grantor trust and thus takes the position that all items of income and deduction of the sub-trust flow through to the taxpayer. The IRS then alleges that the distressed assets held by the sub-trust are either written off as worthless under Internal Revenue Code § 166 or sold at a loss and deducted under Code § 165.



IRS Arguments

According to the IRS, the main purpose of the distressed asset transaction is to shift the built-in loss from the distressed assets from the party not subject to U.S. taxation to the U.S. taxpayer. The IRS asserts that the U.S. taxpayer has not incurred an actual economic loss and thus the U.S. taxpayer cannot deduct the built-in loss from the distressed assets.

Other IRS arguments against the distressed asset transaction include assertions that:

- when the taxpayer transferred cash or a note to the trust in exchange for becoming a beneficiary of the trust, this constituted a transfer of the distressed assets, and gain or loss on the distressed assets should have been calculated under Code § 1001;
- the trust is not a trust for Federal tax purposes and should not be afforded the benefits of trust taxation;
- one or more of the entities is a partnership for Federal tax purposes and thus subject to the revised regulations under the American Jobs Creation Act of 2004 that a built-in loss from distressed assets held by a partnership cannot be transferred by transferring the interest in the partnership;
- the transfer of the distressed assets was not a transaction undertaken for profit and thus no loss deduction is allowable under Code § 165;
- the judicial doctrines of substance over form, lack of economic substance, and step transaction apply to disallow the mechanics of the transaction; and
- the distressed assets were already worthless when contributed to the trust and the sub-trust and thus no deduction is allowable under Code § 166.

Action Steps

Taxpayers

Notice 2008-34 applies to all distressed asset transactions entered into after October 22, 2004. Taxpayers who participated in such transactions are required to disclose the transaction by completing Form 8886, Reportable Transaction Disclosure Statement. A taxpayer who participated in a distressed asset trust transaction after October 22, 2004, and has already filed his/her Federal individual income tax return for the tax year in which the transaction occurred, must amend such return by filing Form 1040-X, Amended U.S. Individual Income Tax Return, and attaching Form 8886.

The filing of Form 8886 does not automatically indicate that the tax benefits claimed in connection with the transaction will be disallowed or that the taxpayer will automatically be audited. This form enables the taxpayer to explain the merits of the transaction to the IRS. If the IRS is not satisfied with the response, they may issue a request for more information.



Taxpayers who fail to disclose these transactions by filing Form 8886 may be subject to a penalty of \$100,000, in case of a natural person, or \$200,000 in any other case.

Advisors

A material advisor to the distressed asset trust transaction is any person who provided any material aid, assistance or advice with respect to organizing, managing, promoting, selling, implementing, insuring or carrying out any reportable transaction. Notice 2008-34 requires material advisors to the distressed asset trust transaction to disclose the assistance on Form 8918, Material Advisor Disclosure Statement.

Failure by a material advisor to a distressed asset trust transaction to file such Form 8918 may subject the material advisor to a penalty in the amount of \$200,000 or 50 percent of the gross income derived from providing aid, assistance or advice on the transaction, whichever is greater.

In addition, material advisors are now required under this Notice 2008-34 to maintain a list of all taxpayers who participated in a distressed asset trust transaction and to whom the material advisor provided aid, assistance or advice. This list must be made available to the IRS upon request.

Failure to provide such a list of investors to the IRS upon request within 20 business days after the date of such request subjects the material advisor to a penalty of \$10,000 per day of failure after the 20th day.

Key Dates

Taxpayers who participated in a distressed asset trust transaction must file an amended Form 1040-X and include Form 8886, Reportable Transaction Disclosure Statement, by **May 27, 2008**, which is 90 days after the date such transaction was identified as a listed transaction.

Material advisors to taxpayers who participated in a distressed asset trust transaction must file Form 8918, Material Advisor Disclosure Statement, and should prepare a list of investors for disclosure to the IRS as needed.

Material advisors to taxpayers who participated in a distressed asset trust transaction should prepare a list of such taxpayers, since this list would be due within 20 days after an IRS request.

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