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Internal Revenue Service
Memorandum

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date: October 23, 2007

to: Joanne Zhang
International Examiner
(Large & Mid-Size Business)

from: David Rakonitz
Attorney (San Francisco, Group 1)
(Large & Mid-Size Business)

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subject: Gain Recognition Agreements and Reasonable Cause Exceptions under § 367

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EIN

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

LEGEND

Agreement 1 =

Agreement 2 =

Agreement 3 =

Amount 1 =
Amount 2 =
Amount 3 =

Amount 4 =
Amount 5 =
Amount 6 =
Amount 7 =
Amount 8 =
Amount 9 =

Business 1=
Business 2 =
Business 3 =
Business 4 =

City 1 =
City 2 =

Class 1 =

Company 1 =
Company 2 =
Company 3=
Company 4 =
Company 5 =
Company 6 =
Company 7 =
Company 8 =
Company 9 =
Company 10 =
Company 11 =
Company 12 =
Company 13 =

Country 1 =
Country 2 =
Country 3 =
Country 4 =
Country 5 =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
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Date 6 =
Date 7 =
Date 8 =

Date 9 =
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Date 22 =
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Date 25 =
Date 26 =
Date 27 =
Date 28 =
Date 29 =
Date 30 =
Date 31 =
Date 32 =
Date 33 =
Date 34 =
Date 35 =
Date 36 =

Employer 1 =
Employer 2 =
Employer 3 =
Employer 4 =
Employer 5 =
Employer 6 =
Employer 7 =
Employer 8 =

Entity 1 =

Exhibit 1 =

Fiscal Year 1 =
Fiscal Year 2 =
Fiscal Year 3 =

Fiscal Year 4 =
Fiscal Year 5 =
Fiscal Year 6 =

Law Firm =

Name 1 =
Name 2 =

Number 1 =
Number 2 =
Number 3 =
Number 4 =
Number 5 =
Number 6 =
Number 7 =
Number 8 =
Number 9 =
Number 10 =
Number 11 =

Partnership 1 =
Partnership 2 =

Percentage 1 =
Percentage 2 =
Percentage 3 =
Percentage 4 =
Percentage 5 =

Person 1 =
Person 2 =
Person 3 =
Person 4 =
Person 5 =
Person 6 =

PLR 1 =

Representative 1 =
Representative 2 =

State 1 =
State 2 =

State 3 =

Taxpayer =

Transaction 1 =
Transaction 2 =

University 1 =
University 2 =

Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Year 7 =

ISSUES

1. Whether Taxpayer failed in the tax year ending Date 5 to comply in any material respect with the requirements of its gain recognition agreement ("GRA")?

2. If Taxpayer failed to comply in any material respect with the requirements of its GRA for the tax year ending Date 5, was this failure due to reasonable cause and not due to willful neglect?

3. Whether Taxpayer failed in the tax year ending Date 14 to comply in any material respect with the requirements of Treas. Reg. section 1.367(a)-8?

4. If Taxpayer failed in the tax year ending Date 14 to comply in any material respect with the requirements of Treas. Reg. section 1.367(a)-8, was this failure due to reasonable cause and not due to willful neglect?

5. Whether Taxpayer should receive relief under the doctrine of substantial compliance for either of its failures to comply with the requirements of Treas. Reg. section 1.367(a)-8?

6. Provided that Taxpayer has failed to show reasonable cause, how long does the Internal Revenue Service ("Service") have to assess the liability?

CONCLUSIONS

1. Yes. In its fiscal year ending Fiscal Year 1, Taxpayer failed to comply with a material requirement of the GRA because its GRA failed to show the correct fair market

values of the transferred stock and limited partnership interest. The difference between the fair market value and the basis was over $55 million.

2. No. For Fiscal Year 1, Taxpayer failed to show that its violation of Treas. Reg. section 1.367(a)-8(b)(2) was due to reasonable cause and not due to willful neglect. Before he signed the GRA under penalties of perjury, Person 1, the vice president of Taxpayer, should have recognized the obvious errors in the GRA and had Person 2, Taxpayer's accountant, correct them. Person 1's failure to recognize the errors was negligent. Furthermore, it took Taxpayer over 5 years to identify the original error.

3. Yes. In its fiscal year ending Fiscal Year 4, Taxpayer failed to comply with Treas. Reg. section 1.367(a)-8(g)(1) by not giving the Service notice about a transfer of stock. It thus failed to comply with a material requirement of Treas. Reg. section 1.367(a)-8.

4. No. For Fiscal Year 4, Taxpayer failed to show that its violation of Treas. Reg. section 1.367(a)-8(g)(1) was due to reasonable cause and not due to willful neglect. By failing to inform its tax preparer about a Year 4 stock exchange that Taxpayer intended to qualify as a reorganization under section 368(a)(1)(B)[1], Taxpayer did not act reasonably. Taxpayer may not avoid its responsibilities by trying to delegate them to an employee of Company 1.

5. No. Taxpayer failed to comply with the GRA requirements for Fiscal Year 1 and the substantial compliance doctrine should not apply. Properly reporting the fair market value of the transferred assets constitutes an essential requirement of the GRA, and the GRA represents the essence of section 367(a)(1). Taxpayer understated the fair market value of the transferred assets by over $55 million. The significance of the GRA and the taxpayer's promise in the GRA to pay the gain associated with the transferred assets is undercut when the Service, upon examination of the GRA, cannot determine the amount of gain claimed by the taxpayer. The substantial compliance doctrine should not treat this error as merely procedural. Further, the substantial compliance doctrine should not apply to Taxpayer's failure to comply with Treas. Reg. section 1.367(a)-8(g)(1) for Fiscal Year 4. Taxpayer did not meet any of the requirements of this provision; it did not partially comply. Allowing relief under the substantial compliance doctrine would improperly render the entire provision meaningless and unenforceable.

6. Since Taxpayer did not identify itself to the Service until the Service received on Date 22 Representative 1's letter dated Date 21, the Service has until Date 36 to assess the tax. The statute of limitations is extended by three years from the date that Taxpayer gave the service actual notice of the mistakes. Treas. Reg. section 1.367(a)-8(c)(2).

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[1] All section references are to the Internal Revenue Code of 1986, as amended.

FACTS

In the spring of Year 7, Representative 1 of Law Firm contacted Large and Mid-Size Business ("LMSB") personnel to inform them that one of his clients would like to make a request for reasonable cause consideration under Treas. Reg. section 1.367(a)-8. Treas. Reg. section 1.367(a)-8 deals with gain recognition agreement requirements. Representative 1 did not disclose his client's name.

On Date 21, Representative 1 submitted a letter identifying the taxpayer and laying out some of the facts relating to the taxpayer's errors with respect to the GRA requirements. The taxpayer is Taxpayer. On Date 23, Representative 1 submitted a letter that laid out additional facts and made a request for reasonable cause consideration under Treas. Reg. section 1.367(a)-8(c)(2) for a transaction that occurred during Taxpayer's Fiscal Year 4. As part of the Exhibits attached to the Date 23, Representative 1 included declarations from Person 3, an employee of Company 1, and Person 2, who was Taxpayer's accountant.

In his letter dated Date 24, Representative 1 requested that the facts and legal analysis contained in his letter dated Date 23 be applied also to a misstated fair market value shown on the GRA attached to Taxpayer's federal income tax return for its fiscal year ending Fiscal Year 1. As part of its annual GRA certification required under Treas. Reg. section 1.367(a)-8, Taxpayer attached a copy of its original GRA to its subsequent year tax returns for the fiscal years ending Fiscal Year 2, Fiscal Year 3, Fiscal Year 4, Fiscal Year 5, and Fiscal Year 6.

In his letters dated Date 23, Date 24, Date 26, and Date 29, Representative 1 provided written responses to the Service's written questions. Person 1 reviewed Law Firm's submissions to the Service and agreed with the facts in those submissions.[2] Representative 1 made arrangements for the LMSB team to interview the individuals who were involved with the relevant transactions. The LMSB team and LMSB Counsel conducted those interviews.

On Date 30, Representative 1 and Representative 2, one of the current POAs from Law Firm representing Taxpayer, had a telephone conference with members of the Service and Office of Chief Counsel. At the end of the telephone conference, the parties agreed that Representative 1 would submit additional facts and arguments in support of Taxpayer's request for reasonable cause relief.

Representative 1 submitted a letter dated Date 34 with exhibits to the Service. This letter included among its exhibits a declaration from Person 1, Taxpayer's vice president and the president of Company 1, and a declaration from Representative 2. It also included supplemental declarations from Person 3 and

[2] Person 1, Date 33 ("Person 1 Declaration"), ¶ 3, p. 1.

Person 2. Representative also sent a handwritten letter dated Date 34 to , Director of Field Operations.

This statement of facts provides below background information on Taxpayer and Company 1, a State 1 corporation that advises Taxpayer. This statement of facts then summarizes Taxpayer's transactions, which occurred in Year 3 and Year 4, discusses Taxpayer's annual certification form, and briefly states how Taxpayer's president in Year 7 learned about the problems with Taxpayer's GRA. Finally, it summarizes the relevant portions of each of the Service's interviews with Person 1, Person 2, and Person 3. The facts stated below are based on information obtained from written responses and notes taken during the interviews. Both Representative 1 and Representative 2 were present at the interviews. This memorandum references the declarations of Person 1, Person 2, Person 3 and Representative 2 as appropriate.

I. Background on Taxpayer and Company 1

Taxpayer a holding company, is the parent corporation of a group of U.S. corporations. Taxpayer filed consolidated U.S. federal income tax returns for the years at issue. Taxpayer did not have a tax department, an accounting department or any employees during the years at issue.[3]

Company 2, a Country 1 company, wholly owns Taxpayer. Company 3, a Country 1company, wholly owns Company 2. Company 3 is a holding company for Business 3. A Country 1 trust, which was established by Person 4 of Country 2 for the benefit of himself and members of his family, ultimately indirectly owns Percentage 1of Company 3. Person 4 is the president of Company 2 and Taxpayer.

Company 1, a State 1 corporation, pursuant to an advisory services agreement provides Business 2 to Company 3, Taxpayer, and entities related to Company 3. Under the Agreement 1, Company 2 retained Company 1 to provide asset management services, transaction services, and investment services. The Agreement 1 superceded a previous Year 1 agreement. In the agreement, Company 1, upon written request, was to "provide employees to serve as officers or directors of the Entity 1 or the Portfolio Companies."[4] Person 1 signed the Agreement 1 as the president of Company 1 and in his individual capacity.

The parties superceded the Agreement 1 with the Agreement 2. The Agreement 2 stated that Company 3 wanted to continue to use Company 1 for itself and various related entities, which would have included Taxpayer, and wanted Company 1 to "undertake the duties and responsibilities hereinafter set forth on

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[3] Representative 1's Representative 1letter dated Date 24, Items #1-4, p. 1-3.
[4] Agreement 1, p. 1-2. As stated, Person 1 held the position of vice-president of Taxpayer.

behalf of, and subject to the supervision of, Name 1 and the Entity 1."[5] Under the Agreement 2, Company 1 continued to provide asset management services, transaction services, and investment services. Person 1 signed the Agreement 2 as the president of Company 1 and in his individual capacity.

II. Transaction 1

A. Organizational Chart Before the Transaction 1

As mentioned previously, Company 2 owned Percentage 1 of Taxpayer, which owned Percentage 1 of Company 4, a U.S. corporation. Taxpayer filed consolidated U.S. federal income tax returns for the years at issue. Company 4 is one of the subsidiaries in Taxpayer's consolidated group. Company 4 and Partnership 1, an unrelated party, each owned Percentage 3 of Company 5, a State 2 corporation. Company 4 and Partnership 1 each also owned Percentage 2 of Partnership 2, a State 2 limited partnership. The remaining Percentage 4 of Partnership 2 was owned by Company 5.

B. The Transaction 1

On Date 4, in a Section 351 exchange, Company 4 transferred its Percentage 2 limited partnership interest in Partnership 2 and its Percentage 3 interest in Company 5 to Company 6., a Country 3 corporation. In exchange, Company 4 received a Percentage 5 interest in Company 5. Before the completion of the transaction, Taxpayer and the other parties involved with the transaction submitted a request for a private letter ruling ("PLR") to secure favorable tax treatment for the transaction. Person 1 was knowledgeable about the transaction, worked to insure that it was implemented, and reviewed the factual portion of the PLR request.[6] In response to this request, the Service issued PLR 1, which, among its holdings, allowed Company 4 to have the tax basis of the Company 6 stock that it received be equal to the basis of the assets transferred by Company 4 to Company 6.[7] In the PLR, Company 4 represented to the Service that it would enter into a five-year GRA in a form provided in Treas. Reg. section 1.367(a)-8. The PLR is based on the facts and representations submitted by Company 4 and Taxpayer. This memorandum collectively refers to the transaction described in PLR 1 as the "Transaction 1."

The basis of the assets transferred by Company 4 to Company 6 was approximately Amount 1. In the materials supporting its private letter ruling request, Taxpayer valued the total FMV of the properties transferred by

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[5] Agreement 2, p. 1-2.
[6] Person 1 Declaration, ¶ 6, p. 2.
[7] This summary describes only a part of the entire transaction considered by the PLR.

Company 4 at Amount 2,[8] but it did not allocate the fair market value between the stock in Company 5 and the limited partnership interest in Partnership 2.

C. Organizational Chart after the Transaction 1

Taxpayer continued to own Percentage 1 of Company 4. After the Transaction 1 occurred, Company 4 owned Percentage 5 of Company 6. Company 6 owned Percentage 3 of Company 5 and Percentage 2 of Partnership 2.

D. Preparation of GRA for Fiscal Year 1

Taxpayer attached a GRA with its federal tax return for Fiscal Year 1. Representative 2 drafted the GRA. Representative 2 claims that she left blank on the GRA both the fair market values of the transferred assets and the basis of the transferred assets.[9] At the time she drafted the GRA, Representative 2 had the information on the fair market values in her work files involving Taxpayer's PLR. The following statements were made on page one of Taxpayer's original GRA:

> (ii) Description of Property Transferred. (1) The property transferred by Company 4 consists of (A) Number 1 Class 1 shares of common stock of Company 5, with an estimated fair market value as of the date of the transfer of approximately Amount 4, an adjusted tax basis of Amount4 and an acquisition date of Date 2, and (B) a Percentage 2 limited partnership interest in Partnership 2., a State 2 limited partnership , with an estimated fair market value as of the date of transfer of approximately Amount 5 an adjusted tax basis of Amount 5 and an acquisition date of Date 2.

As stated before, this valuation of the assets was incorrect. The total fair market value of the transferred stock and partnership interest was actually Amount 2. Person 5, manager at Company 10, signed the tax return on Date 8; Person 1, as vice president of Taxpayer, signed the tax return on Date 10.

The value of the contribution to the Transaction 1 was based on private equity valuation.[10] Person 1 and Representative 2 participated in the PLR request process for the Transaction 1. During the PLR request process, Person 1 became aware of the reporting requirement under Treas. Reg. section 1.367(a)-8.[11]

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[8] Exhibit 1 to PLR Request, dated Date 3; Representative 1's letter dated Date 21.
[9] Representative 2 Date 31 Declaration ("Representative 2 Declaration"), ¶ 8, p. 3; Person 2's oral testimony on Date 28.
[10] Person 1's oral testimony on Date 27.
[11] Representative 1's letter dated Date 26, Item #12, p. 4.

In addition to signing the Fiscal Year 1 Form 1120 under penalties of perjury, Person 1 separately signed the GRA under penalties of perjury that he had examined the GRA and to the best of his knowledge and belief, the GRA was true, correct and complete. Person 1 was aware that the fair market value of the properties exchanged by Company 4 was Amount 2 before signing Taxpayer's federal income tax return for Fiscal Year 1 and before he signed the GRA.[12]

Person 2's staff did not have the correct fair market value for the GRA until after Company 10 sent the tax return for Fiscal Year 1 to Company 1 for signing. On Date 6, Representative 2 sent the draft of the GRA from Representative 2 to Person 6 with a courtesy copy to Person 2.[13] Person 6 was a staff person with Number 2 to Number 3 years of experience who worked for Person 2 at Company 10. On Date 7, Person 6 sent an email to Representative 2. His email states in part,

> I took a look at [the GRA] and was wondering if there was any progress made with respect to the FMV portions of the statement (related to the transfer of Company 5 stock and the Percentage 2 LP interest in Partnership 2). I'm not sure if it's best to include the tax basis amount as the FMV as I would think that the FMV cannot be calculated given that these are not publicly traded items.

Company 10 apparently forwarded the tax return to Company 1 on Date 8. On Date 9, Representative 2 replied in an email to Person 6 that the total fair market value should be Amount 2. Representative 2 also wrote in her email that she had called Partnership 1's tax counsel to confirm how they had allocated values and suggested an allocation of value. In his interview, Person 2 could not explain why, after Company 10 had received the correct fair market value, the correction was not made to the tax return before the due day on Date 10.

Representative 1 asserts in his Date 34 letter that Person 6 placed the incorrect information on the GRA, but Representative 1 provides no concrete support for this claim.[14] Person 2 has characterized Person 6 as a staff person, who was responsible for basic tasks.[15] Senior staff would check a staff person's work, and a partner, such as Person 2, had final responsibility for the return.

In Representative 1's Date 24 written response to question #14, he wrote, "At Taxpayer, Person 1 reviewed the GRA and the tax returns for Fiscal Year 1 through Fiscal Year 6. In the Service's Date 25 letter to Representative 1, the Service's question #21 asked how Person 1 explained why he did not alert

[12] Representative 1's letter dated Date 26, Item #20, p. 6.
[13] Representative 2 Declaration, ¶ 8, p. 3; Representative 1's letter dated Date 34, Exhibit 4.
[14] Representative 1's letter dated Date 34, p. 5-6.
[15] Person 2's oral testimony on Date 28.

Taxpayer's accountants that the incorrect fair market value was being used. In his letter dated Date 26, Representative 1 responded,

> As noted above, Person 1 was aware of the correct FMV and the need for the Gain Recognition Agreement. Person 1 would not have reviewed the actual tax return or the actual GRA prior to its presentation to him for signature. Like many if not most corporate executives who execute complex tax returns, Person 1 relied on qualified experts to insure that the numbers, details and each line item were correctly prepared before acting. In this case Person 1 would have been aware that the GRA was required and executed that document based on his understanding that it was correctly prepared.

In his Date 33 declaration, Person 1 states in part that he "simply did not notice that the amounts listed as 'estimated fair market value' and 'adjusted tax basis were the same. Of course, in retrospect I wish I had. If I had noticed that the amounts were the same I would have brought the error to Person 2's attention."[16]

III. Annual Certification

For Fiscal Year 2 through Fiscal Year 6, Taxpayer filed an annual certification of the GRA, which was attached to Taxpayer's federal income tax returns. The certification included the following:

> Pursuant to Section 1.367(a)-8(b)(5) of the regulations, the U.S. transferor (Company 4) certifies that the transfers mentioned in the attached Gain Recognition Agreement properly signed and filed in the taxpayer's federal U.S. Corporation Income Tax Form for the Fiscal Year 1 have not been disposed of by the transferee foreign corporation in a transaction that is considered to be a disposition for purpose of this section, including a disposition described in paragraph (e)(3) of this section.
>
> The U.S. transferor also certifies that no taxable disposition of assets have been made by the transferred corporation that are not in the ordinary course of business.

The annual certification was a one page document attached on top of a copy of the original GRA. Like the GRA, it was signed under penalties of perjury. Copies of Taxpayer's original federal income tax returns for Fiscal Year 2 through Fiscal Year 4 indicate that Person 1 signed the annual certification for each year.

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[16] Person 1 Declaration, ¶ 9, p. 3. Please note the discussion below concerning Person 3's testimony about how he reviewed tax documents in preparation for Person 1's signature (see pp. 17-19).

IV. The Transaction 2

On Date 13, Company 4 exchanged all of its ownership (Percentage 5) in Company 6 for Number 4 shares of Company 7, which was valued at Amount 3 (the "Transaction 2"). Company 7 was a publicly traded Country 3 company.[17] Taxpayer wanted the transfer to be a tax free reorganization under section 368(a)(1)(B). Company 4's ownership interest in Company 7 represented less than 5 percent of the total voting power and total value of Company 7's stock.[18]

Taxpayer did not disclose the Transaction 2 on its annual certification for the federal tax years ending Date 14, Date 18, Date 19. Despite the requirement of Treas. Reg. section 1.368-3(c), Taxpayer also did not include a statement with its return describing the Transaction 2.

A. Organizational Chart after the Transaction 2

Taxpayer continued to own Percentage 1 of Company 4, which now owned Number 4 shares of Company 7. Company 7 owned Percentage 5 of Company 6. Company 6 owned Percentage 3 of Company 5 and Percentage 2 of Partnership 2. Person 4 continued to be the president of Taxpayer.[19]

B. Preparation of Tax Return for Fiscal Year 4

Person 3, who joined Company 1 in Year 3, normally provided Taxpayer's tax information to Person 2. He is the principal contact at Company 1 with Person 2.[20] Person 3 knew that with respect to the GRA there were certain reporting requirements; he did not think that the Transaction 2 had to be reported under the section 367 regulations. Person 3 believes that Company 1 sent a summary of a particular Company 4 operating account for the period Date 11-Date 14 to Person 2.[21] This summary included a wire transfer for Amount 6 to Company 1. This amount represented the fee that Company 4 paid to Company 1 for Company 1's assistance with the Transaction 2.[22] Person 3 states in his Supplemental Declaration that Person 2 did not ask any specific questions about the Company 6.[23]

On Date 12, Representative 2 sent an email to Person 2 that Company 4 was proposing the Transaction 2; she commented that the Transaction 2 would

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[17] Representative 1's letter dated Date 23, Item #5, p. 5; Agreement 3.
[18] Based on Person 3's oral testimony on Date 28.
[19] Person 3's oral testimony on Date 28.
[20] Person 3 Declaration, ¶ 4, p. 2.
[21] Supplemental Person 3 Declaration, ¶ 7, p. 3.
[22] Supplemental Person 3 Declaration, ¶ 8, p. 3.
[23] Supplemental Person 3 Declaration, ¶ 8, p. 3.

require additional information to be made with the GRA.[24] This email did not, however, state whether or not the Transaction 2 would occur. The Agreement 3 to finalize the Transaction 2 was dated Date 13. Person 2 could not recall if there was any communication between him and Representative 2 after Representative 2's email on Date 12. Exhibit 6 of the Date 34 letter from Representative 1 consists of a copy of Representative 2's notes from a telephone conference with Person 2 and selected entries from Representative 2's time sheets. These entries include a entry stating that Representative 2l had a telephone conference with Person 1 "regarding share exchange with " A copy of Representative 2's notes from the telephone call with Person 2 states in part that she would send him something on her conclusions regarding the GRA.[25] Person 2 has no notes regarding this conversation.[26] Although the entry for Representative 2's time sheet indicates that she drafted an email regarding GRA consequences, Representative 2 could not locate the document.[27] Exhibit 6 does not include evidence proving that Representative 2 actually informed Person 2 that the Transaction 2 was complete.

In his Date 26 letter, Representative 1 stated in part, "None of Person 1, Person 3 or Representative 2 can recall, after four years, whether or not there was any notification to Person 2 or other personnel at Company 12 about the Transaction 2 after the Transaction 2 was completed."[28] In her Date 31 Declaration, Representative 2 states,

> At the time of the transaction, I believed that Person 2 was aware of the transaction and of the additional reporting requirements relating to the GRA. However, in hindsight, having informed Person 2 of the proposed transaction and the additional Section 367 reporting requirements, I should have checked that Person 2 had information concerning the completion of the Year 4 share exchange.[29]

Given the phrasing of this statement, one cannot be certain whether Representative 2 is now asserting that, at the time of the Transaction 2, she believed that Person 2 was aware of the Transaction 2 being completed. If so, Representative 2 does not identify any evidence to support her assertion, and this assertion does not appear to be consistent with Representative 1's previous statement that Representative 2 could not recall whether or not anyone notified Person 2 about the Transaction 2 after it was completed. Person 2 has stated

[24] Representative 1's letter dated Date 24, attachment 5.
[25] Representative 1's letter dated Date 34, Exhibit 6.
[26] Person 2 Date 32 Supplemental Declaration ("Person 2 Supplemental Declaration"), ¶ 10, p. 3.
[27] Representative 2 Declaration, ¶ 12, p. 6.
[28] Representative 1's letter dated Date 26, Item #27, p. 9.
[29] Representative 2 Declaration, ¶ 15, p. 7.

that he did not learn about the Transaction 2 being completed until Year 7,[30] and he does not change his position in his Date 32 Supplemental Declaration.

Person 2 signed Taxpayer's federal income tax return for Fiscal Year 4 on Date 16; Person 1 signed the return on Date 17. Person 1 signed the GRA certification under penalties of perjury. Person 2 did not discover that the Transaction 2 had taken place until Year 7.[31] When Person 2 learned that the Transaction 2 had occurred, he, at first, did not realize the full scope of the problem because he examined the GRA and saw that there was apparently no difference between the fair market values of the transferred assets and their basis.[32] Given her Date 12 email to Person 2, Representative 2 knew the GRA annual certificate should have been changed because of the Transaction 2.

To Person 1's recollection, no one advised him that the Transaction 2 required any change in the reporting of compliance with the GRA.[33] Person 1 knew of the Transaction 2 and knew that Company 4 had transferred the Company 6 stock. There is no indication that Person 2 specifically asked anyone whether the Transaction 2 had occurred or that Representative 2 followed up with Person 2 about making changes to the GRA certificate. Furthermore, there is no indication that Taxpayer personnel or one of Taxpayer's agents notified Person 2 or his accounting firm that the Transaction 2 had actually occurred.

C. Year 5 Request from Company 11

Representative 2 states that Company 11, a Country 3 law firm, requested in Date 15 that she forwarded to Person 1 a Country 3 tax return that they had prepared for his signature. Representative 2 forwarded the Country 3 tax return to Person 1, who executed it on and then returned the signed Country 3 tax return to Company 11. On its Schedule 91, the Country 3 tax return states that Company 4 had disposed of 1,976 class K shares of Company 6. This is a reference to the Transaction 2. In his supplemental declaration, Person 3 states that, to the best of his recollection, he directed a member of his staff to send a copy of the Company 11 cover letter along with a copy of the executed Country 3 tax return to Person 2.[34] The cover letter contains no suggestion that Company 4 had disposed of the shares of Company 6. Person 2 could not find a copy of either the Company 11 cover letter or the executed Country 3 tax return in his files.[35]

V. Taxpayer Discovers Errors in GRA

[30] Person 2 Declaration ("Person 2 Declaration"), ¶ 17, p. 7.
[31] Representative 1's letter dated Date 23, Item #5, p. 6; Person 1 Declaration, ¶ 17, p. 7.
[32] Representative 2's oral testimony on Date 28.
[33] Person 1 Declaration, ¶ 12, p. 4.
[34] Person 3 Supplemental Declaration ("Person 3 Supplemental Declaration"), ¶ 6, p. 2.
[35] Person 1 Supplemental Declaration, ¶ 10, p. 3.

Representative 2 alleges that in connection with another corporate restructuring, she requested in Date 20 a copy of the Year 3 GRA from Person 2 because she did not retain a copy of the GRA in her files.[36] Representative 2 wanted to confirm her belief that the GRA had reached the end of its five-year term and that the Transaction 2 did not extend the term.[37] Representative 2 mentioned the Transaction 2 to Person 2, who realized that the annual certification did not include the Transaction 2. Person 2 further noted that, according to the GRA, there was no gain realized on the Year 3 exchange because the fair market value and the adjusted basis were equal.[38] Representative 2 recognized that the fair market values listed on the GRA were not correct. Person 1, Person 2, and Person 3 notified the president of Taxpayer, who directed them to notify the Service. On behalf of Taxpayer, Representative 1 then contacted the Service about the GRA.

VI. Date 27 Telephone Interview with Person 1[39]

Person 1, the founder and president of Company 1, serves as vice-president of Taxpayer. In his capacity as vice-president of Taxpayer, Person 1 signs Taxpayer's income tax returns and other related tax documents. Company 1 does not provide tax or accounting services to Taxpayer. Person 1 holds his BS and MBA degrees from University 1. Person 1 has extensive experience in capital raising, property sales, mergers, financial advisory assignments in the Business 1 industry, Business 1 asset management, and Business 1 operation analysis from his employment with Employer 1, Employer 2, Employer 3, and Employer 4. Person 1 also spent two years on the financial management faculty of University 2.

In Year 1, Person 1 founded and became the president of Company 1; Company 1's sole client is Company 3 and Company 3's related entities, including Taxpayer.[40] Since Year 1, Company 1 has assisted Company 3 and its related entities in completing Number 6 to Number 7 transactions involving acquisitions, dispositions, or financing. As president of Company 1, Person 1 identified the Transaction 1 as a suitable potential business transaction. He also assisted in the structuring, negotiating, and implementing of the transaction. As president of Company 1, Person 1 identified the Transaction 2 as a suitable potential business transaction. He also assisted in the structuring, negotiating, and implementing of the Transaction 2.

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[36] Representative 2 ¶ 17, p. 7; Representative 2's oral testimony on Date 28.
[37] Representative 2 Declaration, ¶ 17, p. 7.
[38] Representative 2 Declaration, ¶ 17, p. 8.
[39] Some references are made to Person 3's interview. These references are noted in the footnotes.
[40] Person 1's oral testimony on Date 27.

In Date 1, Person 1 was appointed as vice-president of Taxpayer. As vice-president of Taxpayer, Person 1 signs tax returns, reviews transactions and "does whatever the Board asks."[41] Person 1's duties as vice-president of Taxpayer are further described below:

> [T]o (i) perform the duties of the president in the absence of the president or when the president was unable to act and (ii) perform any other duties as from time to time specified by the board of Taxpayer. In this capacity, Person 1 reviewed and signed tax returns on behalf of Taxpayer.[42]

When undertaking a typical transaction, Person 1 starts talking to business lawyers in Law Firm, who represent Taxpayer. The business lawyers then talk to Representative 2, who does tax planning for Taxpayer, about the details of the transaction. The business lawyers, the tax lawyers, the responsible persons at Taxpayer, and the responsible persons at Company 1 work together to complete the transaction.

Person 1 would lead a transaction if he was the one who ultimately originated it. Since Transaction 1and Transaction 2 were the continuation of Taxpayer's previous Name 2 investments, which were initiated by Person 1, Person 1 led Transaction 1and Transaction 2.[43] Person 1 assisted Taxpayer with the Transaction 2 stock so that Taxpayer would not become a minority shareholder in the wake of corporate restructuring by Company 8, which was also an owner of Company 6.[44]

VII. <u>Date 28 Interview of Person 3</u>

Person 3 holds his BS degree from University 1. Person 3 has extensive financial management and Business 4 experience from his employment with Employer 5, Employer 6, Employer 7 in City 1, and Employer 8 in the Country 4 and Country 5. In Year 3, he joined Company 1 as vice-president to oversee the asset management and transactional assignments conducted on behalf of Company 3 and other related entities, including Taxpayer. He has since been promoted to senior vice-president, which involves making more executive decisions in asset management.

As part of his responsibilities at Company 1, Person 3 assists with the preparation of Taxpayer's federal income tax returns, including the ones for Fiscal Year 1 and Fiscal Year 4. As part of his general practice in assisting in the preparation of Taxpayer's tax returns, Person 3 provides Forms K-1, bank

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[41] Person 1's oral testimony on Date 27.
[42] Representative 1's letter dated Date 24, Item #17, p. 6.
[43] Person 3's oral testimony on Date 28.
[44] Person 1's oral testimony on Date 27.

reconciliations, and other documents, such as escrow statements and loan contracts, to Person 2. Company 9 audited the partnerships in which Taxpayer's subsidiaries were partners. Company 9 also prepared the partnerships' tax returns and Forms K-1. In his oral testimony, Person 3 remembered receiving check lists from Person 2 for the preparation of Taxpayer's tax returns. However, the check lists were not kept except for the ones for recent years.[45] In his supplemental declaration, Person 3 stated that he could only recall checklist concerning reportable or listed transactions. He could not find or recall any specific "checklist or other questions concerning corporate reorganizations or similar transactions."[46]

After he provides the information to Person 2 for the preparation of Taxpayer's tax returns, Person 3 meets with Person 2 or talks with him over the telephone to discuss issues relating to the preparation of the tax returns. After the tax returns are completed, Person 2 sends the tax returns to Company 1. Person 3 and Person 1 review the tax returns. As a general practice, Person 3 reads all pages that need Person 1's signature. Person 3 stated emphatically that he reviewed all documents requiring a signature under penalties of perjury. When asked why he scrutinized the documents so carefully, Person 3 stated that he took the matter very seriously; because of the "under penalty of perjury" clause, he wanted to understand fully the details of the document so that he would be able to fully brief Person 1 about the document that Person 1 would be signing. Thus, according to Person 3, forms and statements containing the penalty of perjury statement stood out for more careful review before he handed them to Person 1 for Person 1's signature.[47]

It was Person 3's understanding at the time that transactions involving investments, such as cash, would have to be disclosed to Person 2. Given this understanding, he recognized that the Transaction 1 had to be disclosed to Person 2 because there was a swap of stock with different values. However, Person 3 considered the Transaction 2 to be unique. The stock swapped carried the same value. Before the Transaction 2, Taxpayer held Percentage 5 of Company 6. To get the same value, the bankers targeted 2,875 million shares of Company 6 at a share price not more than Amount 7.[48] From Person 3's perspective, Taxpayer carried the same economic investment in a different form after the Transaction 2. Person 3 was not aware that the Transaction 2 was reportable for U.S. tax purpose.[49]

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[45] Person 3's oral testimony on Date 28.
[46] Person 3 Supplemental Declaration, ¶ 6, p. 2.
[47] Person 3's oral testimony on Date 28.
[48] Agreement 3 indicates that the share price shall not be less than Number 10 or greater than Amount 8. Company 7 stock exchanged carried the value of Amount 3. Therefore, it is computed that the share price of Company 7 was Amount 8 (Amount 3 / Number 4 shares).
[49] Person 3's oral testimony on Date 28.

Neither Taxpayer nor Company 1 had a formal system in place for tracking the assets that were the subject of the GRA (and the PLR).[50] During the term of the GRA, Person 3 allegedly contacted Name 2 for the holding and disposition of stock exchanged under the GRA.[51]

VIII. Date 28 Interview of Person 2

Person 2 is the tax accountant for Taxpayer. Since Year 2, he has supervised the preparation of Taxpayer's U.S. income tax returns. Person 2 has been in general accounting practice for over Number 8 years. He has been a partner at various accounting firms. At the time that Taxpayer's tax return for Fiscal Year 1 was prepared, Person 2 was with Company 10 in City 1, State 3. After Company 10 collapsed, Person 2 joined Company 12 in City 2, State 3 in Year 4. About Number 9 months before the interview with the IRS team and LMSB Counsel, he joined Company 13 of City 1 as a managing director. During the last Number 10 years, his clients have been U.S. operations with foreign shareholders, similar to Company 3 and its subsidiaries. Person 2 is familiar with international tax law. In his career, Person 2 has prepared about five to eight GRAs.[52] Taxpayer filed its first GRA with its federal income tax return for Fiscal Year 1.

Since Year 2, Person 2 has been responsible for the preparation of Taxpayer's federal income tax returns. Person 2 and his firm were not involved with Taxpayer's PLR request for the Transaction 1.[53] When Company 10 prepared Taxpayer's federal income tax return for Fiscal Year 1, Taxpayer had not yet made available the fair market values of the exchanged properties to Person 2 or his staff.

As a general practice, Person 2 sent a check list to his clients to identify activities that occurred during the tax year. The check list was made available to all personnel involved in the preparation of a client's tax returns. Person 2 as a partner took responsibility for everything on Taxpayer's tax returns.

In his supplemental declaration, Person 3 stated that he did not recall receiving any checklists from Person 2 other than checklists concerning reportable or listed transactions.[54] Person 3 could not find or recall any specific checklist or other questions concerning corporate reorganizations or similar transactions.[55] In his oral testimony, Person 3, however, stated that he did not retain notes or checklists for the tax return ending Date 14. Person 2 could not locate any "Tax-Technical Checklists" for Taxpayer. Person 2 has not been able to locate

[50] Representative 2's oral testimony on Date 28; Person 3's oral testimony on Date 28.
[51] Person 3's oral testimony on Date 28.
[52] Person 2's oral testimony on Date 28.
[53] Person 2's oral testimony on Date 28.
[54] Person 3 Supplemental Declaration, ¶ 5, p. 2.
[55] Person 3 Supplemental Declaration, ¶ 5, p. 2.

documents showing the questions that he asked Person 3 related to the tax return for the tax year ending Date 14. In his supplemental declaration, Person 2 stated that,

> The only Tax-Technical Checklist that I found is one pertaining to reportable transactions. There are no checklists that pertain to reorganizations or similar transactions. I do not recall using other Tax-Technical Checklists than that pertaining to listed transactions with regard to this client in the Year 4 tax return preparation process.[56]

Representative 1 claims that Company 12 did not use any questionnaires or checklists in connection with the preparation of Taxpayer's tax return, other than a listed transaction checklist.[57] If one reviews carefully the above statement from Person 2, it indicates that Person 2 cannot locate any checklists other than one related to listed transactions and that he does not remember using any other checklists with regard to Taxpayer's Year 4 tax return. This does not mean that he did not actually use any other checklists with regard to Taxpayer's Year 4 tax return. If Person 2 in fact did not use a checklist for Taxpayer's return, that would be inconsistent with his general practices as described by Person 2 during his oral testimony on Date 28.

It is clear that Person 2 has no accurate recollection of how the error involving the fair market value of the transferred assets occurred. Initially, Person 2 stated that he used in the GRA the value of the basis as the transferred assets' estimated fair market value. He then recanted and said that he did not put the amount of the basis as the transferred assets' estimated fair market value. Person 2 then offered his speculation of what might have happened. He speculated that he contacted Person 3 or Person 1 for the fair market values; Person 3 or Person 1 might have then contacted Representative 2 for the fair market values. As the due day of the tax return got closer and Person 2 still did not know the fair market values, Person 2 believed that he made the decision that the amount for basis would be inserted as the amount for the fair market values. However, he could not recall with certainty who made the actual decision. The completed tax return for Fiscal Year 1 was then sent to State 1 for Person 1's signature.

LAW AND ANALYSIS

I. Overview

This memorandum first provides a brief summary of section 367 and certain GRA requirements. It then examines Taxpayer's reasonable cause claim involving the GRA that it filed in Year 3 and Taxpayer's reasonable cause claim involving the Transaction

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[56] Person 2 Supplemental Declaration, ¶ 11, p. 3-4.
[57] Representative 1's letter dated Date 34, p. 17.

2. This memorandum then considers Taxpayer's claim that the substantial doctrine applies. It considers the applicability of the doctrine to both the GRA filed in Year 3 and also to the Transaction 2, although Taxpayer has not requested that the doctrine apply to the Transaction 2. Finally, this memorandum explains how Taxpayer's errors extend the statute of limitations for assessing a tax on the Transaction 1.

Before discussing the substantive issues, it is worth noting that the GRA signed by Person 1 under penalties of perjury is a three page document. The errors involving fair market values are on the first page of the GRA.

II. Section 367(a)(1)

Subject to certain exceptions, section 367(a)(1) states,

> If, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.

Section 367(a)(1) taxes certain transactions between a U.S. person and a foreign corporation that would not otherwise be taxed under the Internal Revenue Code. A taxpayer may under certain circumstances file a GRA with its tax return in order to avoid the consequences of section 367(a)(1). Treas. Reg. section 1.367(a)-8(b) establishes the specific contents of a GRA. By filing a GRA, the taxpayer, for example, agrees to recognize gain on the transferred property when the foreign corporation disposes of the transferred property. A GRA must include an estimate of the fair market value and the basis of the transferred assets. It is signed under penalties of perjury.

If a taxpayer fails to comply with Treas. Reg. section 1.367(a)-8(b) or the other requirements of Treas. Reg. section 1.367(a)-8, Treas. Reg. section 1.367(a)-8(c)(1) may cause a previously tax free transfer to become a taxable exchange. Treas. Reg. section 1.367(a)-8(c)(1) states in part,

> [I]f a person that has entered into an agreement under paragraph (b) of this section fails at any time to comply in any material respect with the requirements of this section or with the terms of an agreement submitted pursuant hereto, then the initial transfer of property is described in section 367(a)(1) (unless otherwise excepted under the rules of this section) and will be treated as a taxable exchange . . . .

A transfer subject to section 367(a)(1) will not be treated as a taxable exchange if, under all the facts and circumstances, the taxpayer's failure to comply in any material respect with the requirements of Treas. Reg. section 1.367(a)-8 is due to reasonable cause and not due to willful neglect. Treas. Reg. section 1.367(a)-8(c)(2).

In accordance with the representations in its Year 3 private letter ruling request, Taxpayer filed a GRA with its consolidated return for Fiscal Year 1. Under Treas. Reg. section 1.367(a)-8(c)(1), the Transaction 1 will be a taxable exchange if Taxpayer failed to comply in any material respect with the requirements of Treas. Reg. section 1.367(a)-8 and the failure was not due to reasonable cause.

As explained below, Taxpayer's GRA, which it filed with its tax return for the Fiscal Year 1, did not materially comply with the requirements of Treas. Reg. section 1.367(a)-8(b)(2), and Taxpayer lacked reasonable cause for this failure. For Fiscal Year 4, Taxpayer's failure to include the Transaction 2 was a material failure under Treas. Reg. section 1.367(a)-8(c)(1), and Taxpayer lacked reasonable cause for this omission. The substantial compliance doctrine does not apply to either situation. Thus, Taxpayer will recognize taxable gain in Year 3 because the GRA was flawed from its inception. Treas. Reg. section 1.367(a)-8(c)(1).

III. Taxpayer's GRA

This section of the memorandum explains why Taxpayer's failure to file its GRA in accordance with the Treasury Regulations was material and not due to reasonable cause.

A. Failure to Comply was Material

A GRA must contain a description of the transferred property, including an estimate of the property's fair market value and its basis. Treas. Reg. section 1.367(a)-8(b)(2)(i). In its GRA, Taxpayer stated that the Number 1 Class 1 shares of Company 5 common stock as of the date of the transfer had an estimated fair market value of approximately Amount 4 and an adjusted basis of Amount 4. Taxpayer's GRA also stated that the Percentage 2 limited partnership interest in Partnership 2 had as of the date of the transfer an estimated fair market value of approximately Amount 5 and an adjusted tax basis of Amount 5. Taxpayer has acknowledged that these were not the correct fair market values. The combined value of the two transfers was Amount 2, as opposed to the Amount 5 shown on the GRA. Person 1 knew the actual fair market value of the two transfers when he signed the GRA under penalties of perjury. Person 1 either (1) failed to read the GRA when he signed it under penalties of perjury, (2) read the GRA but failed to note the incorrect value, or (3) read the GRA, noted the incorrect value, and failed to correct it. In any of these situations, the taxpayer's failure was material. The value of the transfers constitutes a key piece of information for purposes of enforcing GRAs.

Treas. Reg. section 1.367(a)-8(c)(1) does not define the phrase "comply in any material respect with the requirements of this section." Nevertheless, Taxpayer's error is material. Misstating the fair market value of a transfer by over $55 million is a significant discrepancy. If Taxpayer were to trigger gain under the GRA, the Service would look first to the GRA to determine whether there was any gain. Reliance on

Taxpayer's incorrect GRA would have created the mistaken belief that little or no gain would be due. In fact, when Person 2 learned in Year 7 that Taxpayer had completed the Transaction 2, he did not initially realize the full scope of the problem because he looked at the incorrect fair market values on the GRA.[58] Treating Taxpayer's error as not being material would encourage taxpayers to make unreasonable estimates of the transferred assets' fair market value and would undermine the requirement that the taxpayer include the transferred stock's estimated fair market value in its GRA.

B. No Reasonable Cause

Taxpayer's failure to include the correct fair market values on the GRA was not due to reasonable cause and was negligent. Treas. Reg. section 301.6651-1(c)(1) indicates that a taxpayer can show reasonable cause by demonstrating that he exercised ordinary business care and prudence.[59] Similarly, IRM 20.1.1.3.1(1), which discusses reasonable cause relief from penalties, states in part, "Reasonable cause relief is generally granted when the taxpayer exercises ordinary business care and prudence in determining their tax obligations but is unable to comply with those obligations." Both Treas. Reg. section 301.6651-1(c)(1) and IRM 20.1.1.3.1(1) provide that all the facts and circumstances should be considered when determining whether a taxpayer has reasonable cause. While Taxpayer's situation does not involve a penalty, reasonable cause in this situation should similarly be found if Taxpayer, under all of the facts and circumstances, demonstrates that it exercised ordinary business care and prudence. Taxpayer has not, however, met this standard.

Under the case law, Taxpayer has an independent duty to review its tax return for omissions of income. That obligation may not be delegated to a tax preparer. By extension, the same reasoning should apply to Taxpayer's failure to include the correct fair market value in the GRA. Person 1 knew the actual fair market value of the transferred assets;[60] this is not a case of the taxpayer simply trying to estimate the fair market value in good faith but missing the mark by a wide margin. The difference between the two values was significant. "Negligence under section 6653 is defined as the lack of due care or the failure to do what a reasonable and prudent person would do under similar circumstances." Allen v. Commissioner, 925 F.2d 348, 353 (9th Cir. 1991). Person 1 should have recognized the error, and his failure to recognize such a fundamental error was negligent. Accordingly, the taxpayer's failure to identify and correct the incorrect value was not reasonable. In this section, we first explain the legal basis supporting the conclusion that Taxpayer did not act reasonably. We then evaluate and reject Taxpayer's arguments that providing the information to the Service as part of a private letter ruling request support a finding of reasonable cause. We also evaluate and reject Taxpayer's arguments that policy considerations support a finding of reasonable cause.

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58 Representative 2 Declaration, ¶ 17, p. 7-8; Representative 2's oral testimony on Date 28.

59 Treas. Reg. section 301.6651-1(c)(1) discusses a taxpayer's ability to avoid the penalty for failing to file a tax return and to pay tax by showing reasonable cause.

60 Representative 1's letter dated Date 26, Item #20, p. 6.

1. Taxpayer Did Not Act Reasonably

Taxpayer has argued that it acted reasonably because the Transaction 1 was complex, and it relied upon its advisors to make sure that the GRA had the correct information.[61] While there are situations in which Taxpayer could reasonably rely on Person 2, its tax preparer, this is not one of those cases. The Tax Court has stated, "As a general rule, the duty of filing accurate returns cannot be avoided by placing the responsibility on a tax return preparer." Metra Chem Corp. v. Commissioner, 88 T.C. 654, 662 (1987). In Metra Chem Corp., the Tax Court held that when a cursory review of the tax return would have revealed the error, a taxpayer was negligent and could not shift responsibility for the accuracy of his tax return to his accountant. Metra Chem Corp., 88 T.C. at 662-63. The taxpayers in Metra Chem Corp. had failed to report cash dividends on their tax returns. For one set of taxpayers, the unreported dividends were over 21% of the couple's gross income; the unreported dividends were over 20% of the other couple's gross income. The Tax Court felt that the taxpayers should have noticed such a substantial underreporting of income.

In his Date 26 letter, Representative 1 tried to distinguish Taxpayer's situation from the facts in Metra Chem Corp. [62] He mentioned that GRAs and section 367 are particularly complex. Taxpayer's failure with the GRA did not involve a nuanced interpretation of the section 367 regulations. Taxpayer misstated the fair market value of the transaction on the GRA, and Person 1, the vice president of Taxpayer, failed to correct this basic error. No complex legal questions were involved. Representative 1 has also tried to distinguish Metra Chem Corp. on the grounds that Taxpayer's error did not involve the computation of a tax liability. Taxpayer's misstatement, however, involved estimated fair market values, which would give the Service an indication of how much taxable gain would be likely to arise if the transfer became taxable. If a disposition had occurred and Taxpayer had to recognize tax on the transfer, the use of the wrong fair market values in the GRA might have misled the Service into believing that there was no gain arising from the transaction. At a minimum, Taxpayer's representation about the fair market value of the transferred assets would have been the starting point for the Service to calculate the actual fair market value and the associated gain.

In his Date 34 letter, Representative 1 does not mention Metra Chem Corp. by name, but he indicates that it should be limited to situations where "not discovering the error benefited the taxpayer and harmed the government by enabling the taxpayer to pay less tax than it should have paid."[63] Representative 1 does not refer to any legal authorities to support this position, and the quoted phase assumes away the issue. If the GRA is not valid, Taxpayer's situation involves an error that benefited the taxpayer and harmed the government by enabling the taxpayer to pay less tax than it should have paid. One

[61] Representative 1's letter dated Date 26, Item #22, p. 7-8.
[62] Representative 1's letter dated Date 26, Item #22, p. 7-8.
[63] Representative 1's letter dated Date 34, p. 12.

of Company 4's representations in the PLR was that it would enter into a "five-year gain recognition agreement in the form provided in § 1.367(a)-8 . . . ." The Service issued the PLR based on Company 4's representations, but the GRA did not have the correct fair market values. Instead, the GRA contained numbers that were significantly different from the correct amounts. Notwithstanding its inaccurate representation in the PLR, Company 4 and Taxpayer claimed the benefits of the PLR on their tax return and took advantage of an exception to Treas. Reg. section 1.367(a)-3(a). Treas. Reg. section 1.367(a)-3(a) generally treats section 351 transfers of stock or securities by a U.S. person as taxable exchanges. Representative 1's effort to distinguish Metra Chem Corp. and similar cases is, thus, not persuasive.

The Tax Court has cited Metra Chem Corp. favorably in other cases. The taxpayers in Loftus v. Commissioner failed to report approximately 35% of their taxable income, had partnership losses disallowed by the Service, and had intermingled personal expenses with business expenses. Loftus v. Commissioner, 63 T.C.M. 2944 (1992). In Loftus v. Commissioner, the Tax Court explained that a taxpayer must take certain steps to avoid the negligence penalty by relying upon a return preparer. Loftus v. Commissioner, 63 T.C.M. 2944, 2949 (1992). Citing Metra Chem Corp., the Tax Court then added, "Finally, even if a taxpayer establishes the above requirements, he still has a duty at least to read and make a cursory review of the return and make sure that all income items are included." Loftus, 63 T.C.M. at 2949. The Tax Court then added, "The responsibility to review a return cannot be trivialized." Loftus, 63 T.C.M. at 2949 n.3 (citing Morrow v. Commissioner, 61 T.C.M. 2090 (1991)). The court did not limit a taxpayer's responsibility to review a tax return only to cases involving the substantial underreporting of income. The court in Loftus then concluded that the taxpayer did not have reasonable cause. The taxpayer had failed to provide their tax preparer with all the necessary information, failed to review documents prepared by a bookkeeping service, and also failed to review their return. Similarly, Person 1 did not review the GRA with sufficient care.

In Morrow, the Tax Court determined that the taxpayers had ultimate responsibility for the correctness of their tax return. Although the taxpayers provided their accountant with records, they were sophisticated businessmen, who had failed to review adequately their tax return. The Tax Court stated that the taxpayer should have noticed that certain sale proceeds were not included and that their income was understated by $42,000. Morrow, 61 T.C.M. at 2092. In Taxpayer's situation, the fair market value of the transferred assets exceeded basis by over $55 million. Person 1 did not have to search through the entire tax return to discover the errors in question. Under the terms of the GRA, he was to review the GRA before signing it. A basic review of the first page of the GRA would have identified the errors.

The Tax Court has held a taxpayer responsible for failing to review a tax return even when the error was in a schedule attached to the tax return. One of the issues in Drummond v. Commissioner involved whether a taxpayer's underreporting of gain from the sale of a drawing was due to negligence or disregard of the regulations. Drummond

v. Commissioner, 73 T.C.M. 1959 (1997), aff'd in part, rev'd in part, without published opinion 155 F.3d 558 (4th Cir. 1998).[64] The taxpayer's Schedule C had underreported gain from the sale of a drawing.[65] Even though the issue was a new matter and the Service had the burden of proof, the Tax Court, citing favorably Metra Chem Corp., found that the taxpayer had acted negligently. "Petitioner had an obligation to review that return before filing it." Drummond, 73 T.C.M. at 1974. The Tax Court in Drummond expected the taxpayer to review the Schedule C of the return, which, unlike the GRA, is not separately signed. See also Bilzerian v. Commissioner, 82 T.C.M. 295 (July 24, 2001) (failure to include sale of stock on return not due to reasonable cause). Since the Tax Court in Drummond required the taxpayer to review the Schedule C, which is not separately signed, for accuracy and to notice a basic mistake on the form, the court should also hold Person 1 to the same standard for a GRA, which is separately signed under penalties of perjury.

Although the case involves fraud, the taxpayer's analysis in Allen v. Commissioner is worth noting. Allen v. Commissioner, 128 T.C. 4, 2007 U.S. Tax Ct. LEXIS 7 (2007). In Allen, the taxpayer argued that the three year limitation period for assessment should not be extended when the preparer, as opposed to the taxpayer, has the fraudulent intent. Allen, 2007 U.S. Tax Ct. LEXIS at 9. As support for this position, the taxpayer argued that it would be unfairly burdensome to require taxpayers to keep records indefinitely. The Tax Court strongly rejected the taxpayer's arguments and stated, "We do not find it unduly burdensome for taxpayers to review their returns for items that are obviously false or incorrect. It is every taxpayer's obligation." Allen, 2007 U.S. Tax Ct. LEXIS at 10. Even though this situation does not involve fraud, the Tax Court's emphasis on a taxpayer's responsibility to review a return for obviously false and incorrect items sheds light on this situation. Person 1, as the vice president of Taxpayer, had an obligation to read the GRA with ordinary case. If he had, he would have noticed and corrected the errors located in the GRA.

Taxpayer's facts are readily distinguishable from the situation in Hayward Lumber & Mining Co. v. Commissioner, 178 F.2d 769 (2nd Cir. 1950), which is favorably cited by Representative 1. The issue in Hayward Lumber & Mining Co. was whether the taxpayer's failure to file personal holding company returns was due to reasonable cause and not due to willful neglect. The court determined that reasonable cause was present because the taxpayer had provided its accountant with all the necessary information and relied in good faith on its accountant's advice. Hayward Lumber & Mining Co., 178 F.2d at 771. In Taxpayer's case, the issue for the GRA is far more basic and does not require special knowledge of the Internal Revenue Code. Person 1, Taxpayer's vice president, knew the correct fair market value of the assets transferred in the Transaction 1, but he still signed under penalties of perjury a three page GRA which did not have the correct information. This is a different case from a taxpayer relying on an accountant to know whether a particular kind of return needs to be filed. For similar reasons,

[64] The Fourth Circuit did not address this portion of the Tax Court's opinion. Drummond v. Commissioner, 98-2 U.S.T.C. P50,562 (4th Cir. 1998) (unpublished).
[65] The court ultimately determined that this gain qualified as long-term capital gain, not self-employment income.

Taxpayer's facts also distinguish it from the taxpayer's facts in Stanford v. Commissioner, 152 F.3d 450 (5th Cir. 1998), which determined that the taxpayer could reasonably rely upon his accountant's ultimately incorrect interpretation of section 952. As mentioned previously, in Taxpayer's situation, Person 1 could have corrected the problem with the GRA if he had reviewed the GRA with a little care.

Person 2's oral testimony and the email from Person 6 reveal that the correct fair market value was being discussed by Taxpayer's accountants and its lawyers. According to Person 2 in his interview, he believes that he most likely inserted the basis as the fair market value because he did not know the actual fair market value. Person 3 stated in his oral testimony that he made a point of reviewing carefully documents that were signed under penalties of perjury and properly briefing Person 1 about them. Nevertheless, it remained Person 1's responsibility to correct the errors because the errors were so basic and he signed the GRA as the vice president of Taxpayer.

Taxpayer has been somewhat lax with the requirements of the GRA in another context. Under paragraph (vi) of the GRA, Taxpayer stated that it had made arrangements to insure that Taxpayer and Company 4 would be informed if certain stock dispositions were made. This apparently did not occur except on an informal basis. Given the oral testimony of Person 3 and Representative 2, neither Taxpayer nor Company 1 seemed to have a formal system in place for tracking the assets covered by its GRA at the time of the interviews.

Taxpayer's arguments for reasonable cause undercut the importance of the GRA and the significance of a taxpayer signing a document under penalties of perjury. In question number 21 of its Date 25 letter, the Service asked Taxpayer how Person 1, the vice president of Taxpayer, explained why he did not alert Taxpayer's accountants that the GRA had the incorrect fair market value. Representative 1's responded in part,[66]

> Person 1 would not have reviewed the actual tax return or the actual GRA prior to its presentation to him for signature. Like many if not most corporate executives who execute complex tax returns, Person 1 relied on qualified experts to insure that the numbers, details and each line item were correctly prepared before acting. In this case Person 1 would have been aware that the GRA was required and executed that document based on his understanding that it was correctly prepared.

This explanation is imprecise in its reference to "complex tax returns." As mentioned previously, the document in question is a three page GRA, not the entire return. The errors in question are located in the second paragraph on the first page of the GRA and misrepresent the value of the deal. Person 1 separately signed under penalties of perjury that he had examined the GRA and to the best of his knowledge and belief it was true, correct and complete. Representative 1's answer to question 21 also has

[66] Representative 1's letter dated Date 26, Item #21, p. 6.

some disturbing implications. It seems to suggest that Person 1 had no independent obligation to review the GRA and correct obvious errors, not withstanding that Person 1 had been heavily involved in the Transaction 1, knew the correct fair market value of the transferred assets, and signed the GRA under penalties of perjury. Finding reasonable cause in this situation would encourage taxpayers to sign GRAs without making a basic effort to review the documents for accuracy. If there is little risk that a taxpayer's careless lapse will invalidate a GRA, a taxpayer will have little incentive to make good faith estimates of the fair market value of the transferred assets or to read the terms of the GRA.

In his Declaration dated Date 33, Person 1 states in part, that he "simply did not notice that the amounts listed as 'estimated fair market value' and 'adjusted tax basis were the same. Of course, in retrospect I wish I had. If I had noticed that the amounts were the same I would have brought the error to Person 2's attention."[67] Person 1's later explanation differs from Representative 1's earlier explanation in
because it does not seem to redirect responsibility for reading the GRA to other parties. It thus does not raise the same troubling policy concerns. The underlying issue, however, remains the same. Person 1 did not take sufficient care when he read the GRA to catch an obvious error that he knew to be incorrect. The Service has a strong policy interest in taxpayers preparing and reading the GRA with ordinary care which supports the conclusion that Taxpayer did not act with reasonable cause.

2. Information on PLR Request Does Not Mitigate

As support for a finding of reasonable cause, Representative 1 notes in his Date 34 letter that Taxpayer provided the correct fair market values of the transferred assets to the National Office of the Service. Representative 1 then argues that Taxpayer had no intent not to disclose the information, the Service had the correct information, and that Taxpayer provided the information again when it informed the Service about the problem. Representative 1 also states that the audit team ("Exam") would have requested from a taxpayer almost without exception a copy of the ruling request at the beginning of an audit. These arguments do not bolster Taxpayer's position. Taxpayer can be negligent without having any bad intent. Treas. Reg. section 1.367(a)-8(b)(2) placed the responsibility on Taxpayer to include on its GRA the estimated fair market value of its shares of stock in Company 5 and its limited partnership interest in Partnership 2. Under the regulations, Exam does not need to request later the information from the taxpayer or the National Office, which reviewed the PLR request. The fact that the National Office has the correct information is no substitute for Taxpayer placing the correct information on the tax return where it will be readily available to Exam. If neither the National Office nor Taxpayer could locate the PLR request, it would be more difficult for Exam to confirm what Taxpayer considered the correct fair market value to be. Representative 1's comment in his Date 34 letter that Exam would as a matter of course request the documents making up the PLR request

[67] Person 1 Declaration, ¶ 9, p. 3.

has a "discoverable on audit" flavor to it, which the Service should not encourage.[68] The Service has a right to the information with the return, not later, and should not have to hunt for it.

Representative 1's arguments undermines the integrity of the GRA by implying that Taxpayer's use of an inaccurate estimated fair market value on its GRA should not matter because the Service has the accurate information somewhere else within the organization. This reasoning improperly reduces a taxpayer's responsibility to provide the requested information to the Service in the GRA. Furthermore, the PLR request did not allocate the fair market value between the Company 5 stock and the limited partnership interest in Partnership 2. In his Date 26 letter, Representative 1 identifies Exhibit 1 of the PLR request as containing the fair market value of Company 4's contribution. Exhibit 1 does not allocate the fair market value among the two transferred assets. Before Taxpayer came forward in Year 7, it had not conveyed to the Service how it believed the fair market value should be allocated between the two assets. An agent examining the PLR request would not be able to identify Taxpayer's position on how the Amount 2 total value should be allocated.

3. Policy Issues

Determining that Taxpayer did not have reasonable cause under these facts does not represent an excessive penalty and will encourage taxpayers to review their GRAs more carefully. Representative 1 considers the consequences of Taxpayer's failed GRA as being similar to an excessive penalty.[69] This analogy is misleading. Section 367(a)(1) causes certain kinds of transactions between United States and foreign companies to be taxable unless the transactions meet certain requirements. When corporations fail to satisfy these requirements, the transactions become taxable. That is the substantive tax result for a corporation not having a valid GRA. Taxpayer must satisfy the requirements of section 367(a)(1) and its associated regulations to avoid the general rule; it does not have a general right to treat the transaction as a tax free event.

Besides claiming that the consequences of Taxpayer's errors are excessive, Representative 1 argues that a ruling against Taxpayer would "eliminate the reasonable cause exception."[70] This is not accurate. While the Service has an interest in taxpayers coming forward, it also has an interest in maintaining basic standards for taxpayers who submit GRAs. The difference between the basis and the fair market value of the assets in Taxpayer's situation was over $55 million. Person 1 failed to read the GRA with ordinary care and signed it. Taxpayer did not identify the error for nearly six years. All taxpayers claiming reasonable cause will not be burdened by these damaging facts, and one cannot know the extent that taxpayers will not come forward if Taxpayer receives an unfavorable ruling. Under Treas. Reg. section 1.367(a)-8(c)(2), the standard for determining reasonable cause is based upon "all the facts and

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[68] Representative 1's letter dated Date 34, p. 13.
[69] See Representative 1's Date 34 letter, p.3, 11.
[70] Representative 1's Date 34 letter, p. 12.

circumstances." In this case, simply alerting the Service to the problem, being ready to correct the problem after the fact, and providing the total fair market value of the assets in a private letter ruling request is not sufficient. The importance of establishing a minimum level of conduct for taxpayers submitting GRAs should trump the policy concerns raised by Representative 1.

C. Conclusion

In light of the case law and the specific facts, Taxpayer has not demonstrated reasonable cause regarding the incorrect fair market values that it used in the GRA. Treas. Reg. section 1.367(a)-8(c)(2) provides that the Service must take into account all the facts and circumstances when determining whether Taxpayer's failure to comply was due to reasonable cause. Taxpayer alerted the Service to the problems soon after learning about them and has expressed a willingness to amend its returns as necessary in order to correct the mistakes. Unfortunately, these actions do not outweigh Person 1's failure to read with some basic care a three page document that he signed under penalties of perjury. At the time that he signed the GRA, Person 1 knew the fair market value of the transferred assets. The difference between the basis and the fair market value was so drastic that it should have alerted even a casual reader possessing Person 1's familiarity with the Transaction 1. In addition, Taxpayer did not identify the problem with its GRA for nearly six years but rather perpetuated it by attaching the faulty GRA to its annual certificates. Accordingly, in light of the case law and all the facts and circumstances, Taxpayer did not have reasonable cause with respect to its GRA.

IV. Transaction 2

A. Failure to Comply was Material

Taxpayer's failure to include the Transaction 2 in the annual certification accompanying its GRA was a material failure to comply with the requirements under Treas. Reg. section 1.367(a)-8(c)(1) and Treas. Reg. section 1.367(a)-8(g)(1). Treas. Reg. section 1.367(a)-8(g)(1) states:

> If the U.S. transferor disposes of any stock of the transferee foreign corporation in a nonrecognition transfer and the U.S. transferor complies with reporting requirements similar to those contained in paragraph (g)(2) of this section, the U.S. transferor shall continue to be subject to the terms of the gain recognition agreement in its entirety.

In the Transaction 2, Company 4, which is part of Taxpayer's consolidated return, exchanged its Percentage 5 interest in Company 6 in a nonrecognition agreement under section 368 for shares of Company 7. Taxpayer did not, however, comply with the reporting requirements established by Treas. Reg. section 1.367(a)-8(g)(1) and failed to modify its annual certification to include the Transaction 2.

Failing to include a required transaction in the annual certification is a material failure. Under the regulations, Taxpayer had to notify the Service if Company 4 disposed of the Company 6 stock. Company 4 was the U.S. transferor, and the Company 6 stock was the stock of the foreign transferee. Taxpayers would have little incentive to comply with Treas. Reg. section 1.367(a)-8(g)(1) if they could omit transfers without fear of causing their transaction to be taxable. In his Date 34 letter, Representative 1 makes no attempt to claim that the omission of the Transaction 2 was not a material failure. In light of all of these considerations, the Service should treat Taxpayer's failure to include the Transaction 2 as material.

B. No Reasonable Cause

As discussed previously, reasonable cause is found when a taxpayer, under all of the facts and circumstances, demonstrates that he exercised ordinary business care and prudence. Taxpayer's failure to include the Transaction 2 with its annual certification was not due to reasonable cause despite Taxpayer's argument that "its failure to comply was due solely to the lack of communication between its advisors."[71] In Representative 1's Date 34 letter, Taxpayer's reasons for finding reasonable cause for its failure to comply with Treas. Reg. section 1.367-8(g)(1) can be summarized as follows;

1. No one ever told Taxpayer about the requirement to report the Transaction 2 on its annual certification. Taxpayer believes that its situation is comparable to the taxpayer in Henry v. Commissioner, 170 F.3d 1217 (9th Cir. 1999).

2. Person 2 failed to ask the appropriate questions that would have put either Person 3 or Person 1 on notice regarding the importance of disclosing the Transaction 2.

3. Person 2 was on notice to ask whether or not the Transaction 2 had occurred because of the materials that he received and allegedly received.

4. It is the responsibility of Person 3, not Taxpayer.

5. It is the responsibility of Representative 2, not Taxpayer.

As discussed below, none of these arguments are persuasive. Taxpayer failed to inform its accountant, Person 2, about the Transaction 2 occurring, and it may not avoid its obligations by redirecting the responsibility for informing Person 2 about the completed Transaction 2 back to Person 2, to Representative 2, or to Person 3, an employee of Company 1.

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[71] Representative 1's letter dated Date 23, p.12.

This section will first discuss the significance of Taxpayer's failure to notify Person 2. It will then evaluate and reject each of Taxpayer's arguments.

1. Failure to Notify Person 2

Under Treas. Reg. section 1.6664-4(c), failing to notify Person 2 about the completed Transaction 2 would prevent Taxpayer from reasonably relying upon him to prepare a complete return. Treas. Reg. section 1.6664-4(c) discusses when a taxpayer may reasonably rely on advice in the context of the reasonable cause and good faith exception to section 6662 penalties. This provision should be used as guidance for the purposes of Treas. Reg. section 1.367(a)-8(c)(2) so that the term "reasonable cause" can be applied uniformly. Under Treas. Reg. section 1.6664-4(c)(1)(i), a taxpayer cannot claim to have reasonably relied upon the advice of an advisor unless the advice is based upon all of the pertinent facts and circumstances. Furthermore, the taxpayer must not fail to disclose a fact that it knew or reasonably should have known to be relevant. See Weis v. Commissioner, 94 T.C. 473, 487 (1990). In determining whether taxpayers reasonably relied upon their tax return preparer, the Tax Court noted in Weis that, "To show good faith reliance, the taxpayer must establish that the return preparer was supplied with all necessary information and the incorrect return was a result of the preparer's mistakes." Weis, 94 T.C. at 487. See also Pessin v. Commissioner, 59 T.C. 473, 489 (1972). Taxpayer has an affirmative responsibility to disclose information that it knew or reasonably should have known to be relevant. The Transaction 2, which was intended to qualify as a B Reorganization, falls into this category. Taxpayer had a responsibility to inform Person 2 that it had implemented the Transaction 2 so that he could prepare Taxpayer's tax return accurately.

Taxpayer has a responsibility to file an accurate income tax return. "The general rule is that the duty of filing accurate returns cannot be avoided by placing responsibility on an agent." Pritchett v. Commissioner, 63 T.C. 149, 174 (1974). One of the issues in Pritchett was whether the taxpayers would be liable for a negligence penalty under section 6653. The taxpayers' accountant had failed to include the excess of a mortgage over the property's basis into income. While acknowledging that a taxpayer can in some cases avoid a negligence claim by providing the necessary information to an agent preparing the return, the Tax Court still found the taxpayer to be negligent. The taxpayer was comparatively sophisticated and admitted to reviewing his tax returns. The Tax Court felt that the taxpayer should have noticed the oversight. Although Pritchett precedes United States v. Boyle, 469 U.S. 241 (1985),[72] the Tax Court continues to cite Pritchett for the general principle that a taxpayer is responsible for the accuracy of its tax return. See Kooyers v. Commissioner, 88 T.C.M. 605, 616 (2004).

[72] In Boyle, the U.S. Supreme Court determined that a taxpayer could not rely on his agent to file a timely return. The Supreme Court distinguished that situation from an accountant who advised the taxpayer on substantive tax law.

The case law highlights the importance of a taxpayer providing adequate information to its tax advisor. In Kooyers, the Tax Court identified three criteria that a taxpayer needs to satisfy before it can claim that it had reasonable cause by relying on its tax advisor. These requirements are:

1. The advisor was a competent professional who had sufficient expertise to justify the taxpayer's reliance on him;

2. The taxpayer provided necessary and accurate information to the adviser; and

3. The taxpayer actually relied in good faith on the adviser's judgment.

Kooyers 88 T.C.M. at 616. In Kooyers, the taxpayers failed to prove that their tax advisor was competent and were subject to the accuracy-related penalty under section 6662(a). In Taxpayer's case, Taxpayer failed to inform Person 2 that the Transaction 2 had occurred. It only told him about the proposal, not that the Transaction 2 had occurred.

While Representative 1 provides additional reasons in his Date 34 letter which are addressed later in this section, Person 2's ignorance of the Transaction 2 being completed was initially a core element of Taxpayer's argument for finding reasonable cause. In his Date 23 letter, Representative 1 writes, "Like the tax expert in *Hayward Lumber*, Taxpayer's tax advisor knew about section 367 requirements and its other advisor knew that the stock for stock transaction had occurred." Representative 1's letter dated Date 23, p.15. Representative 1 also states, "Company 1advisers handled the Transaction 2 but failed to fully inform Person 2 of its consummation and Person 2 failed to a lesser extent to ask the correct questions." Representative 1's letter dated Date 23, p.14. Person 3 did not notify Person 2 about the completed Transaction 2. Person 1, Person 3, and Representative 2 cannot recall whether Person 2 or other personnel at Company 12 were notified about the Transaction 2. Representative 2's Date 12 email to Person 2 informs him that Taxpayer 2 was proposing the Transaction 2, but the Service has not received any definitive information showing that he learned of the completed Transaction 2 before Taxpayer 2 filed its tax return. The new information provided in Representative 1's Date 34 letter is discussed later in this section.

Instead of excusing Taxpayer 2's behavior, Taxpayer's failure to give all the necessary information to its tax preparer should be fatal to its claim that it reasonably relied on Person 2 and readily distinguishes its situation from the facts in Hayward Lumber & Mining Co. In Hayward Lumber & Mining Co., the court clearly states that the taxpayer's secretary-treasurer gave all the necessary information to its accountant and that the accountant knew that the taxpayer was a personal holding company. Hayward Lumber & Mining Co., 178 F.2d at 770. When the taxpayer failed to file its personal holding company returns, the court found that the taxpayer's failure was due to reasonable cause. An important factor in that decision was that the taxpayer supplied its accountant with all the necessary information. In Stanford v. Commissioner, 152 F. 3d 450 (5th Cir. 1998), which is also cited by Representative 1, there was no dispute that the taxpayer provided its accountant with all of the necessary information. In contrast, Taxpayer did not inform its accountant that it had completed the Transaction 2. This memorandum discusses Representative 1's references to the Ninth Circuit's decision in Henry later in the memorandum.

2. Taxpayer's Arguments from Date 34 Letter

Representative 1's Date 34 letter contains five arguments to support Taxpayer's position that its violation of Treas. Reg. section 1.367(a)-8(g)(1) was due to reasonable cause. They are as follows:

a. No one ever told Taxpayer about the requirement to report the Transaction 2 on its annual certification. Taxpayer believes that its situation is comparable to the taxpayer in Henry.

b. Person 2 failed to ask the appropriate questions that would have put either Person 3 or Person 1 on notice regarding the importance of disclosing the Transaction 2.

c. Person 2 was on notice to ask whether or not the Transaction 2 had occurred because of the materials that he received and allegedly received.

d. It is the responsibility of Person 3, not Taxpayer.

e. It is the responsibility of Representative 2, not Taxpayer.

As explained below, none of these rationales are persuasive. They fail to address satisfactorily the key issue of Taxpayer's responsibility to notify Person 2, its tax return preparer, about a significant matter, the completed Transaction 2. This section discusses each rational below.

a. Lack of Notification to Taxpayer

Taxpayer's argument that no one told either Person 1 or Person 3 about the requirements of Treas. Reg. section 1.367(a)-8(g)(1) is irrelevant because it does not address Taxpayer's responsibility to fully inform its tax preparer about relevant facts, such as the completed Transaction 2. As mentioned previously, Treas. Reg. section 1.6664-4(c)(1)(i) provides that in order to rely upon an advisor, in this case Person 2, a taxpayer must not fail to disclose a fact that it knew or reasonably should have known to be relevant. The completion of the Transaction 2 is clearly significant and relevant. After the transaction, Company 4 no longer owned the Company 6 shares. Given their lack of familiarity with the Tax Code, Person 1 and Person 3 should have notified Person 2 about the Transaction 2 which was supposed to qualify as a B reorganization so that he could deal with all the consequences of the transaction on Taxpayer's tax return.

While Person 1 and Person 3 did not know all of the tax consequences associated with the Transaction 2, they should have exercised ordinary care and alerted Taxpayer's tax preparer about the transaction. Knowing to inform Person 2 about a completed business transaction does not require any special expertise. Since Person 2 did not learn of the completed transaction until Year 7, he could not, for example, include the statement required by Treas. Reg. section 1.368-3(c) with the original return. Representative 2 did not involve herself with preparing tax returns; Person 2 is the tax return preparer. In order to get the benefit of Person 2's judgment, Taxpayer had to inform him about the completed Transaction 2. The U.S. Supreme Court's decision in Boyle does not excuse a taxpayer from withholding basic information from its tax return preparer.

Representative 1 cites the Ninth Circuit's decision in Henry as being similar to Taxpayer's situation, but it is readily distinguishable. In Henry, the taxpayers, Person 1 and his wife, filed a section 83(b) election for certain options that Person 1 received for services to IMED Corporation and reported the fair market value of the options as zero. The taxpayers sold the options in 1982 and reported a long term capital gain on the sale. Under Treas. Reg. section 1.83-7(b)(2), the taxpayers should have treated the proceeds from the sale of the options as ordinary income. The Ninth Circuit considered whether the taxpayers acted negligently under section 6653(a) and held for the taxpayers.

The taxpayers in Henry successfully argued that they acted in good faith and reasonably relied upon the advice of their tax accountant, Robert E. Douglas. The taxpayers claimed that, "Douglas made the ultimate decision to classify the option proceeds as long-term capital gain and they had no reason to doubt his professional judgment." Henry, 170 F.3d at 1219. The Tax Court had rejected the taxpayers' argument because they had failed to provide Mr. Douglas with copies of the options and thus had not fully informed Mr. Douglas of the underlying facts. The Ninth Circuit, however, noted that Mr. Douglas had testified that "he alone determined that the option proceeds should be classified as long-term capital gain on petitioners' 1982 tax return." Henry, 170 F.3d at 1220. The taxpayers provided Mr. Douglas with the Form W-2 which did not list the option proceeds as compensation income and informed Mr. Douglas that it was their understanding that IMED Corporation's general counsel had structured the stock options to achieve long-term capital gains. Mr. Douglas had the option of contacting the stock option program managers if he wished. The Ninth Circuit stated that,

> Douglas never requested copies of the options and there is no evidence that petitioners knew or should have known that the options themselves were relevant

> to Douglas' tax treatment of the option proceeds. We deem it reasonable that a taxpayer would not know the relevant information his or her accountant needed to proceed with preparation of tax returns unless the accountant requests such information.

Henry, 170 F.3d at 1220. Representative 1 only quotes the last sentence of the above citation in his Date 34 letter, but it needs the previous sentence for proper context. The accountant knew about the existence of the options but failed to ask for additional information that would have proved helpful. The court is not suggesting that taxpayers have no responsibility to provide relevant information to their accountant. The Ninth Circuit also commented that Mr. Douglas did not actually need the options to make an informed decision about their proper tax treatment and was aware that the Service might apply Treas. Reg. section 1.83-7(b)(2) to the options. Id. The taxpayer's accountant in Henry knew about the sale of the options and characterized it improperly. Neither Taxpayer nor its representatives explicitly informed Person 2 that the Transaction 2 had actually occurred. While the accountant in Henry knew that the options existed, Person 2 did not know that Taxpayer had implemented the Transaction 2.

In contrast, the taxpayers in Collins v. Commissioner participated in a mining venture that lacked economic substance but claimed that they were not subject to negligence penalties because they relied upon the advice of their accountant. Collins v. Commissioner, 857 F.2d 1383 (9th Cir. 1988). The Ninth Circuit rejected this argument in Collins because the accountant knew nothing firsthand about the mining venture. Collins, 857 F.2d at 1386. Person 2, similarly, was not aware that the Transaction 2 had occurred. In Collins, the Ninth Circuit referred favorably to Leonhart v. Commissioner for the position that taxpayers cannot rely on accountant's advice when that advice was not based on knowledge of all the facts. Leonhart v. Commissioner, 414 F.2d 749, 750 (4th Cir. 1969). In Leonhart, the Fourth Circuit found that the taxpayers could not in good faith rely upon the erroneous advice of their accountant because the taxpayers failed to show that the accountant based his advice on all of the facts. Leonhart, 414 F.2d at 750. While the economic substance of the Transaction 2 is not in question, the key point is the importance of providing information to the accountant.

b. Person 2's Failure to Ask Appropriate Questions

Taxpayer should not be able to claim reasonable cause by claiming that Person 2 failed to ask the proper questions. As discussed previously, Taxpayer had a separate duty to inform Person 2 about the completed Transaction 2. In his declaration, Person 2 states that he learned about the Transaction 2 in Year 7.[73] Lacking employees with tax expertise, Taxpayer had an independent obligation to take steps to insure that its Transaction 2 was properly reported. It cannot blame Person 2 for its failure. Person 2,

[73] Person 2 Declaration, ¶ 17, p. 7.

an experienced accountant, testified that it was his custom to give checklists designed to obtain information from his clients. Taxpayer intended the Transaction 2 to qualify as a reorganization under section 368(a)(1)(B). For a basic reorganization under section 368(a)(1)(B), it seems likely that the Company 12 checklist would have had at least one question designed to identify such tax free reorganizations. Taxpayer's failure to alert Person 2 about the completed Transaction 2 also meant that Taxpayer's tax return for Fiscal Year 4 did not include a required statement about the section 368 reorganization, that was an integral part of the Transaction 2 and is required by Treas. Reg. section 1.368-3(a).

In his Date 34 letter, Representative 1 argues that Person 2 did not use any checklists to prepare Taxpayer's tax return for Taxpayer's tax year ending Date 14. Person 2 stated in his oral interview that he customarily used checklists designed to obtain information from his clients, but in his supplemental declaration he did not recall using "other Tax-Technical Checklists than that pertaining to listed transactions with regard to this client in the Year 4 tax return preparation."[74] Person 3 does not recall receiving any checklists other than checklists concerning reportable or listed transactions. From Person 3's supplemental declaration, it is not clear whether Company 1 has in its possession checklists concerning reportable or listed transactions. Given Person 3's statement during his interview, Taxpayer apparently did not keep old checklists.

While it seems very unlikely that an experienced accountant like Person 2 would have discontinued his usual practices and not provided Taxpayer with various questions designed to uncover relevant pieces of information, it does not change the analysis if Person 2, in fact, did not provide Person 3 or another representative of Taxpayer with a checklist. Taxpayer reasonably should have known that it had to disclose the Transaction 2 to Person 2 so that he could prepare Taxpayer's return accurately. Effectively acting as Taxpayer's agent, Person 3 should have alerted Person 2 that the Transaction 2, which he believed to be a non-taxable event,[75] had occurred. Person 2 could then have used his expertise to make sure that Taxpayer's tax return reflected this transaction.

c. Person 2 Received Adequate Notice of Transaction

In Representative 1's Date 34 letter, he suggests that Person 2 received adequate notice of the completed Transaction 2 and that Person 2 should have checked to determine the status of the Transaction 2. Representative 1's Date 34 letter provides the following reasons for this view:

1. Representative 2 discussed the contemplated transaction with Person 2 and its possible tax consequences.

[74] Supplemental Person 2 Declaration, ¶ 11, p. 4.
[75] Supplemental Person 3 Declaration, ¶ 9, p. 3.

2. Person 2 supposedly received a cover page from Company 11 to Representative 2 and a copy of the Country 3 tax return that shows the disposition of the Company 6 shares in one of its schedules.

3. Person 2 allegedly received an account summary showing a wire transfer for Amount 6 to Company 1 for a transaction fee.

None of these pieces of information constitute adequate or reasonable notice to Person 2 that the Transaction 2 had actually occurred. Person 2's failure to follow up on these pieces of information does not relieve Taxpayer of its responsibility to inform him of the business transactions that it has completed in a tax year. Representative 2's discussion with Person 2 about a transaction under consideration and its consequences to the GRA does not constitute notice that the transaction actually occurred. These discussions occurred in Year 4; Company 12 did not prepare the return until Year 5. Representative 1's approach would have discussions about tentative transactions qualify as adequate notice to tax preparers, but that is not consistent with the standard of Treas. Reg. section 1.6664-4(c). For a taxpayer who wants to rely upon its tax return preparer, Treas. Reg. section 1.6664-4(c) imposes upon a taxpayer the responsibility to disclose facts that it knew or reasonably should have known to be relevant to its tax return preparer. Taxpayer either knew or should have known that exchanging its interest in Company 6 as part of the Transaction 2 was significant, but it failed to inform Person 2 about the completed Transaction 2.

Since Person 2 was unable to locate the Country 3 tax return prepared by Company 11, it is not certain that Person 3's staff actually sent the document to him. Even if Person 2 received the documents, Person 2 received no notice on how this document might be significant. The cover letter to Representative 2 does not indicate that the Transaction 2 occurred, and the information is not located in the return but on an attached schedule. Without any notice of the document's significance, neither Person 2 nor his staff would have any reason to comb the document for information about transactions that he would reasonably expect Person 3 to mention when they discussed the preparation of Taxpayer's tax return.

Presuming that Person 2 received the statement showing the wire transfer to Company 1 for a transaction fee, the statement does not provide enough information to Person 2. The entry references a transaction fee to Company 1 but provides no other information. The failure of Person 2 and his staff to track down the reason for this entry does not mitigate Taxpayer's obligation to state clearly that it had engaged in a B reorganization. This is just another example of Taxpayer's effort to shift its responsibilities on to other parties. In order to provide notice to its tax preparer, Taxpayer had to provide him with more than a theoretical scenario and hidden clues.

d. <u>Taxpayer May Not Shift Blame to Person 3</u>

Even though Person 3 stated in his oral testimony that he was not aware that the Transaction 2 had to be reported for tax purposes, Taxpayer should not be able to shift its responsibility for providing Person 2 with accurate information to Person 3, an employee of Company 1. As mentioned previously, the Tax Court has been wary of taxpayers trying to delegate responsibility for filing accurate tax returns to their agents. While there is an exception for relying upon tax advisors if the taxpayer can satisfy certain requirements, Person 3 is not a tax advisor. Lacking a background in taxation, Person 3 did not understand the tax implications of the Transaction 2 for either the GRA or as a tax free reorganization under section 368. Taxpayer is not justified in treating Person 3 in the same category as Person 2 for purposes of determining reasonable cause. Responding to Company 12's requests for information and supplying tax information to an accountant is very different from preparing tax returns and resolving tax questions. In his role as a conduit between Taxpayer and Taxpayer's accountant, Person 3 is acting like any other corporate employee who is the primary contact with the corporation's outside accountant. As the Tax Court noted, "[T]he taxpayer may have to bear the consequences of any negligent errors committed by his or her agents." Kooyers, 88 T.C.M. at 616.

If Person 3 had been a Taxpayer employee, there would be little question that Taxpayer would be unable to claim that it had relied on Person 2 to prepare accurate returns because it, through an employee, failed to notify Person 2 about the completed Transaction 2. Taxpayer, however, has no employees. Unless Person 1 or another Taxpayer officer contacts Person 2 on behalf of Taxpayer, all of Taxpayer's contacts with Person 2 will be through third parties. Accordingly, Taxpayer is trying to use its lack of employees as an excuse to insulate itself from its responsibilities to convey complete information to its accountant and to file an accurate tax return. While Company 1's Agreement 1 specifies that no agency is created by that agreement, Person 3 was for practical purposes acting as Taxpayer's agent when he provided Taxpayer's tax information to Taxpayer's accountant. In this context, Taxpayer should be held responsible for the actions of Person 3. Whether Taxpayer chooses to have employees or not to have employees should not make any difference to Taxpayer's responsibility to provide Person 2 with complete and accurate information.

e. Taxpayer May Not Shift Blame to Representative 2

In Representative 1's Date 34 letter, he suggests that Taxpayer had reasonable cause because it relied on Representative 2, but we conclude that Taxpayer's reliance on Representative 2 would not excuse its failure to comply with Treas. Reg. section 1.367(a)-8(g)(1). Representative 2 knew that Taxpayer would need to modify its annual certificate after the Transaction 2 was completed, but she does not recall conveying this information to Person 1, Person 3, or anyone else associated with Company 1or Taxpayer.[76] This lapse does not excuse Taxpayer's actions. Representative 2 was not

[76] Representative 2 Declaration, ¶ 14, p. 6.

Taxpayer's tax return preparer;[77] Taxpayer had no basis to rely on her to prepare accurately its tax returns. Taxpayer had an obligation to file accurate tax returns, and Taxpayer may not try to rely on Representative 2 when Taxpayer fails to inform its tax return preparer about its completed Transaction 2.

Representative 2 states in her declaration that she had complete knowledge of all the significant facts and later states, "The Year 4 tax return filing error in not reporting the required information about the Year 4 exchange was not due to the failure of the taxpayer, Taxpayer to provide its tax experts with all necessary information."[78] The completeness of Representative 2's knowledge does not extend to Person 2. They work in different organizations, and Representative 2, unlike Person 2, has no responsibility for the preparation of Taxpayer's tax return. Representative 2 acknowledges that, to the best of her recollection and belief, she did not instruct Company 1 or Taxpayer to inform Person 2 about the completed Transaction 2. Neither Taxpayer nor its representatives informed Person 2, the tax return preparer, that the Transaction 2 had actually occurred. Accordingly, Representative 2's effort to absolve Taxpayer of any responsibility for the error arising from the Transaction 2 is not consistent with the facts and should not be accepted at face value. The issue is not whether Taxpayer's "tax advisors" collectively knew about the Transaction 2 but whether Person 2 and Company 12, who were responsible for preparing Taxpayer's tax return, knew that the Transaction 2 had been completed. The evidence shows that Taxpayer did not inform Person 2. Accordingly, Taxpayer cannot claim to have relied upon him to prepare its tax return accurately because it failed to disclose to him pertinent facts.

C. <u>Conclusion</u>

As with the review of the GRA, the Service must consider all the facts and circumstances in determining whether or not Taxpayer's failure to materially comply with the regulations was due to reasonable cause. While Taxpayer notified the Service about its failures to comply with Treas. Reg. section 1.367(a)-8, that is not sufficient to prove that its failures were due to reasonable cause. Under the case law, Taxpayer lacked reasonable cause because it did not notify its accountant about the completed Transaction 2. While Representative 1's Date 34 letter and Person 2's oral testimony on Date 28 indicates that there is a disagreement over whether Person 2 asked sufficient questions to uncover whether a reorganization occurred, Taxpayer had a separate affirmative obligation to inform Person 2 that the Transaction 2 occurred. Choosing an employee of Company 1 to convey information to Person 2 should not allow Taxpayer to avoid its responsibilities. The difference between a corporation having employees as opposed to outside consultants who perform the same functions does not merit granting Taxpayer's request for reasonable cause. The Service should not provide any incentive for a corporation to hire an outside party to act as a buffer

[77] Representative 2 Declaration, ¶ 10, p. 4, ¶ 18, p. 8.
[78] Representative 2 Declaration, ¶ 20, p. 9.

between itself and its accounting firm. In light of all of these considerations, Taxpayer did not act with reasonable cause when it failed to file a correct annual certification form in Year 4, Year 5, and Year 6 as required by Treas. Reg. section 1.367(a)-8(g)(1).

V. Substantial Compliance Doctrine

The substantial compliance doctrine should not apply to Taxpayer's initial errors with its GRA or to its error regarding the Transaction 2. This section first provides a general overview of the substantial compliance doctrine. It then evaluates whether the doctrine should apply to Taxpayer's initial errors with its GRA and determines that the substantial compliance doctrine should not apply. While Taxpayer has not argued that the substantial compliance doctrine applies to the error regarding the Transaction 2, this section considers whether the substantial compliance doctrine should apply to the Transaction 2 in order to be thorough and concludes that the doctrine should not apply.

A. Overview

When it applies, the substantial compliance doctrine allows a taxpayer to satisfy a statutory or regulatory requirement, such as an election, even though the taxpayer has not complied with all of the requirements of the statute or regulation. The Ninth Circuit has described the substantial compliance doctrine as "[A]n equitable doctrine designed to avoid hardship in cases where the party does all that can be reasonably expected of him." Sawyer v. County of Sonoma, 719 F.2d 1001, 1008 (9th Cir. 1983). The Ninth Circuit added that the doctrine could not be used to defeat the policies of the underlying statute. Id. Although Sawyer does not involve taxes, the Tax Court has cited Sawyer favorably. Dirks v. Commissioner, T.C. Memo 2004-138, aff'd unpublished, 2005 U.S. App. LEXIS 24885 (9th Cir. 2005). See Estate of Chamberlain v. Commissioner, T.C. Memo 1999-181, aff'd without published opinion, 2001 U.S. App. LEXIS 10911 (9th Cir. 2001). The Tax Court has also applied the substantial compliance doctrine to cases where a taxpayer has not satisfied all of the requirements of a regulation. See American Air Filter Company, Inc. v. Commissioner, 81 T.C. 709 (1983).

The case law regularly notes that the substantial compliance doctrine will not apply to requirements that relate "to the substance or essence of the statute." Taylor v. Commissioner, 67 T.C. 1071, 1077 (1977) (citing Sperapani v. Commissioner, 42 T.C. 308, 331 (1964)). If the requirement relates to the substance or essence of the statute, a taxpayer must strictly comply with the requirement and substantial compliance is not available. Similarly, the substantial compliance doctrine cannot be used to defeat the policies of the underlying statute. Estate of Chamberlain, 1999 Tax Ct. Memo LEXIS 217, 42. If the uncompleted requirement is procedural or directory and does not relate to the essence of the statute, the substantial compliance doctrine will apply. Taylor, 67 T.C. at 1077-78. Identifying the essence of a statute is critical to determining whether substantial compliance applies. The courts sometimes couch this analysis in terms of mandatory requirements that must be strictly followed, and procedural requirements, which are subject to substantial compliance.

The general principles of the substantial compliance doctrine are well defined, but application of these principles can be difficult. While the Tax Court has applied the doctrine more liberally in the past with American Air Filter Company, Inc. v. Commissioner, 81 T.C. 709 (1983), more recent cases seem to have applied the doctrine more restrictively. See Prussner v. United States, 896 F.2d 218 (7th Cir. 1990); The Credit Life Insurance Company v. United States, 948 F.2d 723 (Fed. Cir. 1991).[79]

B. Taxpayer's GRA

The GRA relates to the essence of section 367(a) because it represents a means for taxpayers to avoid the general prohibition established by section 367(a)(1), and the fair market value requirement relates to the essence of the GRA. The requirement that a taxpayer estimate the fair market value of transferred assets, thus, relates to the essence of section 367(a). Congress enacted section 367(a) and its predecessor to close a tax avoidance loophole. H.R. 98-432, pt. 2, 1315 (1984). Congress was concerned that without section 367(a) taxpayers would otherwise be able to use certain nonrecognition provisions to remove tax-free appreciated assets from U.S. tax jurisdiction. Id. at 1307. The GRA provides a route for taxpayers to avoid the consequences of section 367(a)(1). See Treas. Reg. section 1.367(a)-3(c)(1)(iii).

Treas. Reg. section 1.367(a)-8(b)(2)(i) requires that the estimated fair market value of the transferred assets be included in the GR. Representative 1 considers this requirement to be merely procedural,[80] but it actually relates to the essence of the GRA. Without an accurate fair market value, one cannot determine the gain associated with the transaction. As required by Treas. Reg. section 1.367(a)-8(b)(1)(iii), Taxpayer and Company 4 agreed to recognize gain in accordance with the requirements of Treas. Reg. section 1.367(a)-8(b)(3). This agreement to recognize gain loses significance if the amount of gain cannot be accurately determined. The GRA requires the taxpayer to provide its estimated fair market value of the transferred assets and to commit to the approximate amount of gain at stake. The fair market value information on Taxpayer's GRA was not accurate. Even if Person 2 had included Exhibit 1 of the PLR request, which contains the cumulative fair market value of the transferred assets, with Taxpayer's tax return for Fiscal Year 1, the Service still would not know how Taxpayer intended to allocate the value between the two transferred assets. In order to calculate gain, one must know the asset's fair market value and its basis. The calculation of the gain relates to the essence of the GRA. The GRA relates to essence of section 367(a)(1) because it provides a crucial exception to the statute's general provision. Accordingly, the requirement that Taxpayer provide a good faith estimate of the

[79] The Ninth Circuit, however, has not adopted or rejected the Seventh Circuit's view in a published opinion. In an unpublished opinion, which cannot be cited as precedent, the Ninth Circuit cited Prussner as support for the position that applying the doctrine of substantial compliance is "particularly problematic when deadlines are at issue." Christensen v. Commissioner, 1998 U.S. App. LEXIS 7576, 6 (9th Cir. 1998).

[80] Representative 1's letter dated Date 34, p. 14.

transferred assets' fair market value in its GRA relates to the essence of section 367(a)(1) and is not merely procedural. A review of the factors outlined in American Air Filter supports this conclusion.

The Tax Court in American Air Filter examined whether the taxpayer had substantially complied with the regulatory requirement to make an election under section 963. Before its repeal, section 963 permitted a U.S. shareholder to elect to exclude from its income its share of the subpart F income of one or more of its controlled foreign corporations if the U.S. shareholder received from the controlled foreign corporations minimum distributions that satisfied certain requirements. The taxpayer had not filed the necessary election as required by the regulation but had stated on its request for an extension of time to file that it needed to collect, "[T]he information required with respect to the income from controlled foreign corporations and the related computations of a minimum distribution." American Air Filter, 81 T.C. at 712. While acknowledging that the Service may require full compliance with regulations when the regulations relate to the substance or essence of a statute, the Tax Court determined that the requirement did not relate to the essence of the statute and concluded that the taxpayer had substantially complied with the regulation.

The Tax Court stated in American Air Filter,

> Several factors have been examined in determining whether to permit less-than-literal compliance with regulatory requirements:
>
>> whether the taxpayer's failure to comply fully defeats the purpose of the statute;
>>
>> whether the taxpayer attempts to benefit from hindsight by adopting a position inconsistent with his original action or omission;
>>
>> whether the Commissioner is prejudiced by the untimely election;
>>
>> whether the sanction imposed on the taxpayer for the failure is excessive and out of proportion to the default; and
>>
>> whether the regulation provided with detailed specificity the manner in which an election was to be made.

American Air Filter, 81 T.C. at 719-20.[81] We discuss below each of the five American Air Filter factors and conclude that the substantial compliance doctrine does not apply to Taxpayer's situation.

1. Purpose of the Statute

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[81] We have indented the factors as a convenience.

Congress enacted section 367(a) in order to restrict the ability of taxpayers to use certain nonrecognition provisions to remove tax-free appreciated assets from U.S. tax jurisdiction. The GRA is an important tool for implementing this statutory purpose. By misstating the estimated fair market value of the transferred assets by over $55 million, Taxpayer's error defeats the purpose of the GRA and thus the purpose of section 367(a)(1). A misstated fair market value means that one cannot read the GRA and determine accurately the gain associated with the transaction covered by the GRA. This omission also undercuts Taxpayer and Company 4's commitment to recognize gain because they are not acknowledging in the GRA the correct amount of gain at stake. Treas. Reg. section 1.367(a)-8(b)(1)(iii). A properly completed GRA provides an important exception to section 367(a)(1). Taxpayer's misstatement of the fair market values of the transferred assets defeats the purpose of the GRA and of section 367(a)(1).

[redacted] Congress in the Tax Reform Act of 1984 removed from section 367(a)(1) a principal purpose of tax avoidance test because the Tax Court had defined the "principal purpose test" too narrowly. H.R. 98-432, pt. 2, 1315 (1984). Focusing on the underlying transaction does not take into account the importance of the GRA as an exception to section 367(a)(1) or recognize that Taxpayer's transaction will not be valid without a valid GRA. Given these considerations, this factor supports a finding of no substantial compliance.

2. Whether Taxpayer Benefiting from Hindsight

Taxpayer is not benefiting from hindsight. This factor supports its position.

3. Whether Commissioner Prejudiced by Error

Taxpayer's error has prejudiced the Service. It allows Taxpayer to avoid having to commit itself on the GRA to the correct gain associated with the transferred properties and effectively shifts the responsibility of determining the gain involved in the transaction to the Service. The information in Taxpayer's PLR request does not mitigate the situation. Taxpayer provided the combined fair market value of both assets to the National Office, not to Exam. A risk exists that Exam would not be able to obtain the information contained in the PLR request. A brief review of the GRA might suggest that further investigation was unnecessary because the GRA shows no gain, and Exam might fail to ask for the information. When Person 2 reviewed the GRA in Year 7 with Representative 2, he commented that there was no gain realized on the Year 3 exchange because he was misled by the incorrect fair market values shown on the GRA.[82] An Exam agent could make a similar mistake. Furthermore, even if Exam did

[82] Representative 2 Declaration, ¶ 17, p. 8.

receive the PLR request, the request does not contain a breakdown of the value between the two transferred assets. If Taxpayer had disposed of one but not both of the transferred assets from through , Exam could not know the correct associated gain by reviewing either the GRA or the PLR request. This factor supports a finding of no substantial compliance.

4. Whether Sanction Is Excessive

The consequences of Taxpayer's misstating the fair market value of its transferred assets by over $55 million are not excessive in light of the scope of the misstatement and the underlying facts. Person 1 stated that he read the GRA before signing it, but he did not notice this significant error. As discussed previously, this error undermines the integrity of the GRA by allowing the taxpayer to avoid having to commit to the amount of gain at issue. It also prevents the Service from identifying the amount of gain at issue by reading the GRA. Taxpayer did not make just a procedural error.

When a taxpayer's GRA is not adequate, the underlying transaction becomes taxable. Section 367(a)(1) does not provide for some alternative remedy. Section 367(a)(1) applies unless Taxpayer satisfies certain requirements including signing a valid GRA, and Taxpayer did not meet this requirement. This factor supports a finding of no substantial compliance.

5. Clear Requirements

Treas. Reg. section 1.367(a)-8(b)(2)(i) states clearly that a taxpayer must provide an estimate of the fair market value of the transferred property covered by the GRA. This factor supports a finding of no substantial compliance.

Of the five American Air Filter factors, four favor a finding of no substantial compliance; one favors Taxpayer's position. The substantial compliance doctrine should not apply.

Although not saying so directly, the Ninth Circuit implies that the "purpose of the statute" factor should receive a greater weighting than the other factors. Referencing American Air Filter, the Ninth Circuit agreed that, "Full compliance is necessary when the requirement relates to the substance of the statute or where the essential purposes have not been fulfilled." Shotgun Delivery, Inc. v. United States, 269 F.3d 969, 973-74 (9th Cir. 2001). The Ninth Circuit in Shotgun Delivery did not use the five factor test when it evaluated the taxpayer's claim that its mileage reimbursements had substantially complied with the requirements of a tax-exempt "accountable plan" under the regulations. The Ninth Circuit instead examined the substance of the statute without any reference to the five factors and rejected the taxpayer's argument of substantial compliance. This suggests that a taxpayer's failure to comply fully with the statute's purpose will preclude substantial compliance relief.

Representative 1 refers briefly to Hewlett-Packard Company v. Commissioner, but it does not apply to Taxpayer's situation. Hewlett-Packard Company v. Commissioner, 67 T.C. 736 (1977). The Tax Court determined in Hewlett-Packard Company that the taxpayer had made a valid election to make adjustments for accelerated depreciation in computing the earnings and profits of its foreign subsidiaries even though the taxpayer failed to file a written statement with the Director of International Operations. The Tax Court noted the peculiar facts of the case when it decided that literal compliance with regarding to filing the written statement with the Director of International Operations was not necessary. Since the taxpayer wholly owned the controlled foreign corporations in questions, there were no other shareholders to be notified of the election. The underlying reason for the notice requirement did not apply. Id. at 752-53. Furthermore, the Court noted that the Director of International Operations's responsibilities in this case were essentially ministerial or clerical. "[H]is receipt of the written statements involves no audit functions." Id. at 752. The court took care to observe that the audit function was still safeguarded. Id. The audit function is not similarly safeguarded in Taxpayer's situation. Exam, which has the audit function, did not receive the correct information with the tax return. Over five years later, Taxpayer discovered the error and provided the fair market values. If Exam had audited Taxpayer's GRA before Taxpayer discovered the error, the incorrect information on the GRA could have mislead Exam and would have, in any case, increased the burden upon Exam to locate the correct information.

The Service also argued unsuccessfully in Hewlett-Packard Company that the written statement provided by the taxpayer was not sufficient. The Tax Court noted that the taxpayer had provided all the necessary information with its tax return, even if the information was not part of the written statement. The error did not cause the Service any inconvenience. Id. at 749. Taxpayer, in contrast, did not provide elsewhere on its tax return the correct fair market values for the transferred assets covered by the GRA and placed the burden of tracking down the information on the Service.

Taxpayer's situation is also different from the facts in FSA 200018004 (December 22, 1999).[83] In this Field Service Advice Memorandum ("FSA"), the taxpayer listed certain assets on Form 8023-A using the tax basis of the assets, rather than the fair market values. Form 8023-A is used to make a section 338(h)(10) election. The FSA first concluded that the election was valid without regard to the substantial compliance doctrine. Examining section 338(h)(10), the FSA decided that furnishing the information was not a prerequisite to a valid election. Form 8023-A's instructions state that if an election is made, the taxpayer should attach a schedule listing the appropriate information. This careful analysis of section 338(h)(10) does not apply to Taxpayer's situation. Treas. Reg. section 1.367(a)-8(b)(2)(i) specifically includes an estimate of fair market value in the GRA. Since the FSA concluded that the information was not a prerequisite to a valid section 338(h)(10) election, it is not surprising that the FSA also concludes as an alternative theory that the substantial compliance doctrine applies. In

[83] Field Service Advice does not have precedential value.

Taxpayer's situation, the estimated fair market value of the transferred assets relates directly to the GRA and thus to the essence of section 367(a)(1). FSA 200018004 does not cover this situation.

The Seventh Circuit has explicitly narrowed the application of the substantial compliance doctrine in tax cases. Prussner v. United States, 896 F.2d 218 (7th Cir. 1990). The taxpayer in Prussner failed to file a recapture agreement with its estate tax return as required by the regulations. After criticizing the Tax Court's doctrine of substantial compliance as difficult to apply, the Seventh Circuit stated,

> The common law doctrine of substantial compliance should not be allowed to spread beyond cases in which the taxpayer had a good excuse (though not a legal justification) for failing to comply with either an unimportant requirement or one unclearly or confusingly stated in the regulations or the statute. . .[T]here must be a showing that the requirement is either unimportant or unclearly or confusingly stated . . . .

Prussner, 896 F.2d at 224. Failing to read a document with basic care is not a good excuse. An accurate estimate of the fair market value of the transferred assets listed in the GRA establishes the amount of gain involved and is an important requirement of the regulation. The requirement to include estimated fair market value in the GRA is clearly stated in Treas. Reg. section 1.367(a)-8(b)(2)(i). The Ninth Circuit has not specifically adopted the Seventh Circuit's view of substantial compliance; Prussner, accordingly, is only persuasive authority that the substantial compliance doctrine should not apply in Taxpayer's situation. As mentioned previously, the Tax Court, however, has cited favorably the Prussner position in a case that the Ninth Circuit affirmed in an unpublished opinion. Estate of Chamberlain v. Commissioner, T.C. Memo 1999-181, aff'd unpublished, 2001 U.S. App. LEXIS 10911 (9th Cir. 2001). [84] See also The Credit Life Insurance Company v. United States, 948 F.2d 723, 726 (Fed. Cl. 1991) (declined to adopt reasoning of American Air Filter and adopted Prussner analysis). In light of all of these factors, the substantial compliance doctrine should not apply to the initial error in Taxpayer's GRA.

C. Transaction 2

Although Representative 1 has not suggested that Taxpayer receive relief under the substantial compliance doctrine for its error related to the Transaction 2, this memorandum considers the issue and determines that the substantial compliance doctrine should not apply to Taxpayer's failure to comply with Treas. Reg. section 1.367(a)-8(g)(1). Taxpayer did not notify the Service as required by Treas. Reg. section 1.367(a)-8(g)(1). Taxpayer did not comply at all with this requirement, as opposed to complying partially with the requirement. In this case, use of the substantial

[84] The Ninth Circuit in an unpublished opinion referred favorably to Prussner. Christensen v. Commissioner, T.C. Memo 1996-254, aff'd unpublished, 198 U.S. App. LEXIS 7576, 6 (9th Cir. 1998) (Unpublished). This reference in an unpublished opinion cannot be cited but provides some insight into the Ninth Circuit's perspective.

compliance doctrine would improperly render the entire provision meaningless and unenforceable. The substantial compliance doctrine accordingly should not apply to Taxpayer's error related to the Transaction 2.

D. Conclusion

By treating the requirement to include an estimate of fair market value in the GRA as being merely procedural, Representative 1's argument would in essence remove the Service's ability to use the GRA to determine the gain associated with transferred assets. Setting aside the imagery of the taxpayer effectively hiding the amount of "gain" in a gain recognition agreement ("GRA"), the estimated fair market value of the transferred assets relates to the GRA because it indicates the taxpayer's potential exposure, and the taxpayer acknowledges this exposure by signing the GRA. Granting substantial compliance in this situation would open the door for other taxpayers to treat the requirement of providing estimated fair market value as being essentially meaningless. In this case, the substantial compliance doctrine is for practical purposes a materiality argument in the garb of a judicial doctrine. It should not apply to this situation. With regard to the Transaction 2, the doctrine should not comply because Taxpayer has not complied at all with the disclosure requirement of Treas. Reg. section 1.367(a)-8(g)(1).

VI. Statute of Limitations

By filing IRS Form 8838, Taxpayer extended the statute of limitations for the assessment of the Transaction 1 until September 30, 2007. When there is a material failure to comply with Treas. Reg. section 1.367(a)-8, the period for assessing the tax is extended until three years after the date on which the Service received actual notice of the failure to comply. Treas. Reg. section 1.367(a)-8(c)(1). The Service received actual notice on Date 22 when it received Representative 1's letter dated Date 21, which identified for the first time Taxpayer as the taxpayer. Before that time, Representative 1 had not identified his client and thus not given actual notice to the IRS. Thus, the statute of limitations should be extended to Date 36.

VI. Conclusion

We recommend that the Service determine that Taxpayer's errors relating to both the GRA and the Transaction 2 were material errors and not due to reasonable cause. Taxpayer did not act with ordinary business care and prudence when Person 1 failed to correct the error on the GRA, and Taxpayer did not act with ordinary business care and prudence when Taxpayer failed to notify its tax preparer about the completed Transaction 2. We also conclude that the substantial compliance doctrine should not apply to either situation. Since Taxpayer failed to comply with Treas. Reg. section 1.367(a)-8(c)(1) and did not satisfy the reasonable cause exception, the initial transfer of property covered by the GRA should be treated as a taxable exchange for Fiscal Year 1 because that is the year of the failure to comply with the GRA. This material failure to comply extends the period for assessment of tax on the gain until three years after the date on which the Service received actual notice of the failure to comply. Treas. Reg. section 1.367(a)-8(c)(1).

VII. Recommendations

Taxpayer does not have a valid GRA as required by Treas. Reg. section 1.367(a)-8. The substantial compliance doctrine should not apply. We recommend that the Service open Taxpayer's tax year for Fiscal Year 1 and make an adjustment showing the Transaction 1 as being taxable under section 367(a)(1).

Since Taxpayer did not have reasonable cause, Taxpayer's transfer of stock and of a limited partnership interest is taxable under section 367(a)(1). Treas. Reg. section 1.367(a)-8(c)(1) provides that the now taxable transaction will be treated as occurring in the year of the initial transfer or, if a suitable election was made, in the year that the failure to comply with the regulation occurred. Since Taxpayer's failure to comply with the regulations occurred during its tax year ending Date 5, the year of the initial transfer and the year of the failure to comply are identical. Accordingly, Exam should treat the Transaction 1 as generating taxable gain in Year 3, as opposed to Year 4. The error in Year 3 occurred first and should determine the tax year in which Taxpayer recognizes taxable gain from the Transaction 1.

As explained previously, Taxpayer's failure to comply with the requirements of its GRA in Year 3 was not due to reasonable cause; in Year 4, Taxpayer's failure to include the Transaction 2 in its annual certification was also not due to reasonable cause. Individually, either failure would be sufficient for a violation under Treas. Reg. section 1.367(a)-8(c)(1). When one considers both incidents and the underlying facts together, Taxpayer's conduct becomes even less reasonable and creates the impression of a larger pattern of neglect.

Please call (415) 227-5143 if you have any further questions.

LAUREL M. ROBINSON
Associate Area Counsel
(Communications, Technology & Media: San Francisco)

By: ______________________________
David Rakonitz
Attorney (San Francisco, Group 1)
(Large & Mid-Size Business)