New Phoenix Sunrise Corp. & Subsidiaries v. Commissioner of Internal Revenue, 132 T. C. 161 (U. S. Tax Ct. 2009)

In *New Phoenix Sunrise Corp. v. Commissioner*, the U. S. Tax Court ruled that a complex tax shelter known as the BLISS transaction lacked economic substance and was designed solely for tax avoidance. The court disallowed a claimed $10 million loss, upheld the disallowance of legal fees, and imposed accuracy-related penalties on the taxpayer, New Phoenix Sunrise Corp. , emphasizing the importance of the economic substance doctrine in evaluating tax shelters.

Parties

New Phoenix Sunrise Corporation and its subsidiaries (Petitioner) v. Commissioner of Internal Revenue (Respondent). New Phoenix was the petitioner at the trial level before the U. S. Tax Court.

Facts

New Phoenix Sunrise Corporation, a parent company of a consolidated group, sold substantially all of the assets of its wholly owned subsidiary, Capital Poly Bag, Inc. , in 2001, realizing a gain of about $10 million. Concurrently, Capital engaged in a transaction called the "Basis Leveraged Investment Swap Spread" (BLISS), involving the purchase and sale of digital options on foreign currency with Deutsche Bank AG. Capital contributed these options to a newly formed partnership, Olentangy Partners, in which it held a 99% interest and its president, Timothy Wray, held a 1%. The options expired worthless, and Olentangy Partners dissolved shortly thereafter, distributing shares of Cisco Systems, Inc. , to Capital, which Capital sold at a nominal economic loss but claimed a $10 million tax loss. New Phoenix reported this loss on its consolidated tax return to offset the $10 million gain from the asset sale. The IRS issued a notice of deficiency disallowing the claimed loss and imposing penalties under section 6662 of the Internal Revenue Code.

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency to New Phoenix on September 14, 2005, determining a deficiency of $3,355,906 and penalties of $1,298,284 for the tax year 2001. New Phoenix filed a timely petition with the U. S. Tax Court on December 8, 2005. The case was tried in the Tax Court's Atlanta, Georgia session on January 22 and 23, 2008. The parties stipulated that any appeal would lie in the U. S. Court of Appeals for the Sixth Circuit.

Issue(s)

Whether the BLISS transaction entered into by Capital Poly Bag, Inc. , lacked economic substance and should be disregarded for federal tax purposes?

Whether the legal fees paid to Jenkens & Gilchrist in connection with the BLISS

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transaction are deductible by New Phoenix?

Whether New Phoenix is liable for accuracy-related penalties under section 6662 of the Internal Revenue Code?

Rule(s) of Law

The economic substance doctrine requires that a transaction have a practical economic effect other than the creation of income tax losses. *Dow Chem. Co. v. United States*, 435 F. 3d 594 (6th Cir. 2006).

Under section 6662 of the Internal Revenue Code, accuracy-related penalties may be imposed for underpayments due to negligence, substantial understatements of income tax, or valuation misstatements.

Holding

The U. S. Tax Court held that the BLISS transaction lacked economic substance and was therefore disregarded for federal tax purposes. Consequently, the court disallowed the $10 million loss claimed by New Phoenix. Additionally, the court held that the legal fees paid to Jenkens & Gilchrist were not deductible because they were related to a transaction lacking economic substance. Finally, the court imposed accuracy-related penalties on New Phoenix under section 6662 for a gross valuation misstatement, substantial understatement of tax, and negligence.

Reasoning

The court analyzed the economic substance of the BLISS transaction, finding that it lacked any practical economic effect. The transaction involved a digital option spread with Deutsche Bank, where Capital purchased a long option and sold a short option, contributing both to Olentangy Partners. The court found that the design of the transaction, including Deutsche Bank's role as the calculation agent, ensured that Capital could not realize any economic profit beyond the return of its initial investment. The court also noted that the transaction was structured solely to generate a tax loss to offset the gain from the asset sale, without any genuine business purpose or profit potential.

The court rejected New Phoenix's arguments that the transaction had economic substance based on the testimony of its expert witness, who argued that similar trades were done for purely economic reasons. The court found the expert's testimony unpersuasive in light of the transaction's structure and the lack of any realistic chance of economic profit.

Regarding the legal fees, the court applied the principle that expenses related to transactions lacking economic substance are not deductible. The court found that the fees paid to Jenkens & Gilchrist, which were involved in promoting and implementing the BLISS transaction, were not deductible under section 6662.

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The court imposed accuracy-related penalties under section 6662, finding that New Phoenix had made a gross valuation misstatement by overstating its basis in the Cisco stock, substantially understated its income tax, and acted negligently by relying on the advice of Jenkens & Gilchrist, which had a conflict of interest as a promoter of the transaction. The court rejected New Phoenix's argument that it had reasonable cause and acted in good faith, finding that reliance on Jenkens & Gilchrist's opinion was unreasonable given the firm's conflict of interest and the taxpayer's awareness of IRS scrutiny of similar transactions.

Disposition

The U. S. Tax Court upheld the Commissioner's determinations in the notice of deficiency and found New Phoenix liable for the section 6662 accuracy-related penalties.

Significance/Impact

New Phoenix Sunrise Corp. v. Commissioner is significant for its application of the economic substance doctrine to a complex tax shelter. The decision reinforces the principle that transactions lacking economic substance cannot be used to generate tax losses. It also highlights the importance of independent tax advice and the potential consequences of relying on the opinions of transaction promoters. The case has been cited in subsequent tax shelter litigation and serves as a reminder to taxpayers of the IRS's focus on economic substance in evaluating tax transactions. The ruling underscores the need for careful scrutiny of transactions designed primarily for tax avoidance, emphasizing that such transactions may be disregarded and penalties imposed under section 6662.

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