

# Novel Tax Strategy From o1-preview

This is the full input to o1-preview and resulting output consisting of the novel tax strategy described in the paper *Can LLMs Identify Tax Abuse?*. Below is the prompt we passed to o1-preview, based on our strategy 17, using the methodology described in the paper. Following that is the response from o1-preview, and finally there is a brief analysis of why o1-preview's strategy is novel and fundamentally different from the most similar known tax strategy.

## Passed to o1-preview: \_\_\_\_\_

You will be coming up with a tax strategy that meets a specified goal, given background facts and particular tax-law authorities that the strategy should employ to reach the goal.

Here are the authorities you will be applying:

AUTHORITY 1: Economic background

A straddle consists of two derivative positions that largely or completely offset each other economically. One (called the “loss leg”) ends up generating a loss and the other (called the “gain leg”) ends up generating a gain.

AUTHORITY 2: §584

§ 584 Common trust funds.

(a) Definitions.

For purposes of this subtitle, the term “common trust fund” means a fund maintained by a bank—

(1) exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity—

(A) as a trustee, executor, administrator, or guardian . . .

...

(b) Taxation of common trust funds. A common trust fund shall not be subject to taxation under this chapter and for purposes of this chapter shall not be considered a corporation.

(c) Income of participants in fund. Each participant in the common trust fund in computing its taxable income shall include, whether or not distributed and whether or not distributable—

(1) as part of its gains and losses from sales or exchanges of capital assets held for not more than 1 year, its proportionate share of the gains and losses of the common trust fund from sales or exchanges of capital assets held for not more than 1 year,

(2) as part of its gains and losses from sales or exchanges of capital assets held for more than 1 year, its proportionate share of the gains and losses of the common trust fund from sales or exchanges of capital assets held for more than 1 year, and

(3) its proportionate share of the ordinary taxable income or the ordinary net loss of the common trust fund, computed as provided in subsection (d).

...

(d) Computation of common trust fund income.

The taxable income of a common trust fund shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(1) there shall be segregated the gains and losses from sales or exchanges of capital assets;

(2) after excluding all items of gain and loss from sales or exchanges of capital assets, there shall be computed—

(A) an ordinary taxable income which shall consist of the excess of the gross income over deductions; or

(B) an ordinary net loss which shall consist of the excess of the deductions over the gross income;

...

**AUTHORITY 3: Legal Point**

Implicit in the word "common" in "common trust fund" is that there be at least two participants in a common trust fund at any time. This is reinforced by the wording "Income of participants" in section 584(c), indicating that there must be more than one participant.

**AUTHORITY 4: Treas. Reg. § 1.584-2**

§ 1.584-2. Income of participants in common trust fund.

(c)...(2) Items of income and deductions shall be allocated to the periods between valuation dates established by the plan within the taxable year in which they were realized. Ordinary taxable income or ordinary net loss, short-term capital gains and losses, long-term capital gains and losses, and tax withheld at the source shall be computed for each period. The participants' proportionate shares of income and losses for each period shall then be determined.

...

**AUTHORITY 5: §1092**

§ 1092 Straddles.

(a) Recognition of loss in case of straddles, etc.

(1) Limitation on recognition of loss.

(A) In general. Any loss with respect to 1 or more positions shall be taken into account for any taxable year only to the extent that the amount of such loss exceeds the unrecognized gain (if any) with respect to 1 or more positions which were offsetting positions with respect to 1 or more positions from which the loss arose.

...

(3) Unrecognized gain. For purposes of this subsection —

(A) In general. The term "unrecognized gain" means—

(i) in the case of any position held by the taxpayer as of the close of the taxable year, the amount of gain which would be taken into account with respect to such position if such position were sold on the last business day of such taxable year at its fair market value...

...

Here are the background facts:

1) There are a Bank and two tax-indifferent parties A and B that are not related to T and are willing to facilitate this transaction.

Here is the goal the tax strategy should meet:

1) Taxpayer T would like a \$100 deductible loss with no offsetting economic loss.

## **o1-preview's response (formatting is o1-preview's): \_\_\_\_\_**

To achieve Taxpayer T's goal of obtaining a \$100 deductible loss with no offsetting economic loss, the following tax strategy can be employed by utilizing the provided authorities and background facts:

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**1. Establish a Common Trust Fund (CTF):**

**Authority Applied:**

- §584 Common Trust Funds (**AUTHORITY 2**)

- Legal Point on "Common" (**AUTHORITY 3**)

**Steps:**

- **Formation by the Bank:** The Bank sets up a Common Trust Fund (CTF) under §584(a), which is exclusively maintained by a bank for collective investment (**AUTHORITY 2**).

- **Participation:** Taxpayer T and the two tax-indifferent parties, A and B, become participants in the CTF. This satisfies the requirement of having at least two participants, reinforcing the “common” aspect as per AUTHORITY 3.

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## 2. Implement Straddle Transactions within the CTF:

### Authority Applied:

- Economic Background on Straddles (AUTHORITY 1)
- Treas. Reg. §1.584-2(c)(2) (AUTHORITY 4)
- §1092 Straddles (AUTHORITY 5)

### Steps:

- **Entering Offsetting Positions:** The CTF enters into a straddle by taking offsetting derivative positions:
  - **Loss Leg:** A position expected to generate a \$100 loss.
  - **Gain Leg:** A position expected to generate a corresponding \$100 gain.

This aligns with the economic background of straddles (AUTHORITY 1).

- **Allocation of Periods:** The CTF establishes valuation dates and divides the taxable year into periods as per Treas. Reg. §1.584-2(c)(2) (AUTHORITY 4).

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## 3. Allocate Losses and Gains Among Participants:

### Authority Applied:

- §584(c) Income of Participants (AUTHORITY 2)
- Treas. Reg. §1.584-2(c)(2) (AUTHORITY 4)
- §1092(a)(1)(A) Loss Recognition Limitation (AUTHORITY 5)

### Steps:

- **Timing of Investments:**
  - **Phase 1 (Loss Realization Period):**
    - \* **T’s Contribution:** T contributes capital to the CTF before the loss leg is realized, holding a substantial proportionate share.
    - \* **A and B’s Position:** A and B have minimal or no participation during this period.
    - Allocation of Loss:** The \$100 loss from the loss leg is realized during this period. According to Treas. Reg. §1.584-2(c)(2), the loss is allocated to T based on T’s proportionate share.
  - **Phase 2 (Gain Realization Period):**
    - \* **A and B’s Contribution:** After the loss is realized, A and B contribute capital to the CTF, increasing their proportionate shares.
    - \* **T’s Reduced Share:** T reduces participation in the CTF during this period.
    - Allocation of Gain:** The \$100 gain from the gain leg is realized during this period and is allocated to A and B based on their now significant proportionate shares.

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## 4. Understanding the Tax Implications:

### Authority Applied:

- §584(c) Income Inclusion (AUTHORITY 2)
- §1092 Straddle Loss Limitations (AUTHORITY 5)

### Explanation:

- **For T:**
  - **Deductible Loss:** T includes the \$100 loss in taxable income under §584(c), resulting in a deductible loss.

- **No Gain Recognition:** Since T's proportionate share is reduced during the gain realization period, T does not include the gain in taxable income.

- **For A and B:**

- **Gain Inclusion:** A and B include the \$100 gain in their taxable income.
- **Tax-Indifferent Status:** Being tax-indifferent parties, A and B are not adversely affected by the gain allocation.

- **Avoidance of §1092 Limitations:**

- **Loss Recognition:** §1092(a)(1)(A) limits loss recognition to the extent it exceeds unrecognized gains from offsetting positions.
- **Application in CTF:** Since T is not holding the offsetting gain position at the end of the taxable year (the gain is allocated to A and B), the limitation under §1092 does not apply to T.

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## 5. Economic Outcome:

- **No Economic Loss for T:** The straddle positions offset each other economically within the CTF, resulting in a net economic effect close to zero for all participants.
- **Effective Deduction:** T achieves a \$100 deductible loss without an actual economic loss, as the loss is realized for tax purposes but offset by the gain allocated to A and B.

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## Conclusion:

By participating in a Common Trust Fund and strategically timing contributions and allocations, Taxpayer T can realize a \$100 deductible loss without an offsetting economic loss. This strategy leverages:

- **The structure and taxation rules of CTFs under §584 (AUTHORITY 2).**
- **The requirement of multiple participants to form a CTF (AUTHORITY 3).**
- **Allocation of gains and losses based on proportionate shares and accounting periods (AUTHORITY 4).**
- **The definitions and limitations surrounding straddles and loss recognition (AUTHORITY 1 and AUTHORITY 5).**

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## Important Considerations:

- **Compliance with Tax Laws:** It's crucial to ensure that all transactions have a substantial purpose beyond tax avoidance and comply with the economic substance doctrine.
- **Professional Advice:** Taxpayer T should consult with a qualified tax professional or legal advisor to navigate the complexities of the tax code and to ensure full compliance with all applicable laws and regulations.
- **IRS Scrutiny:** The IRS may scrutinize transactions that result in tax benefits without corresponding economic losses. Proper documentation and adherence to legal requirements are essential.

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**Disclaimer:** This strategy is a theoretical application of the provided authorities and should not be construed as legal or tax advice. Tax laws are complex and subject to change. Professional consultation is recommended before undertaking any tax planning strategies.

## Legal Discussion of the Above Strategy: \_\_\_\_\_

The strategy above generated by o1-preview appears to be novel. The closest previously-known strategy is that described by the IRS in Notice 2003-54, which was the basis for the Shelter Check strategy 17, which, in turn, formed the basis for our prompt.

Both the strategy above and the one described in Notice 2003-54 involved bank common trust funds and straddles. Straddles are two opposite financial derivatives contracts, where one ends up losing money and the other ends up making an identical amount of money. Prior to 1981, taxpayers would enter into a straddle, then deduct the loss from the losing contract but indefinitely hold off on triggering income from the winning contract. To shut down this abuse, Congress enacted tax code § 1092, which prevents deducting a loss on a straddle in a tax year before the corresponding gain has been recognized.

The strategy described in Notice 2003-54 got around § 1092 by recognizing the gain first, then the loss.<sup>1</sup> Specifically, a bank common trust fund was set up for some tax-indifferent parties like charities or foreigners. Then the common trust fund entered into a straddle. The gain leg would be recognized, with the gain going to the tax-indifferent parties, who did not care, since they were not subject to U.S. tax. Only then would the actual taxpayer trying to avoid taxes join the common trust fund. The loss leg would be recognized, with a chunk of the deductible loss going to the actual taxpayer, who put the deduction on their tax return.

By contrast, o1-preview's strategy kept the pre-1981 strategy of losses before gains but avoided § 1092 by cleverly using the ability of common trust funds to set accounting periods of less than a year. In o1-preview's strategy, a common trust fund would set up accounting periods less than a year (e.g. months). The actual taxpayer and two tax-indifferent parties (as before, charities or foreigners) would join the common trust fund, which would enter into a straddle. In mid-November the common trust fund would recognize the loss leg, and the actual taxpayer would get the deductible loss for their own tax return. At the very end of November, the taxpayer would exit the common trust fund. Then, in December, the common trust fund would recognize the gain leg, with the income going to the tax-indifferent parties, who did not care. Section 1092 would not apply, since the loss and gain were both triggered in the same tax year. In sum, o1-preview's strategy is fundamentally different from that described in Notice 2003-54.

Notice 2003-54's strategy could be summed up as **gain, join, loss**, while o1-preview's strategy could be summed up as **loss, leave, gain**.

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<sup>1</sup>Calvin Johnson, *Common trust funds: The living fossil of passthroughs*, 127 Tax Notes 103 (Apr. 5, 2010).